TRENDS IN MUNICIPAL FINANCING AND THE USE OF TAX-EXEMPT BONDS TO FINANCE PRIVATE ACTIVITIES

HEARINGS

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

NINETY-EIGHTH CONGRESS

FIRST SESSION

JUNE 15 AND 16, 1983

Serial 98-30

Printed for the use of the Committee on Ways and Means

U.S. GOVERNMENT PRINTING OFFICE
25-455 O WASHINGTON : 1984

H781-13

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TRENDS IN MUNICIPAL FINANCING AND THE USE OF TAX-EXEMPT BONDS TO FINANCE PRIVATE ACTIVITIES

WEDNESDAY, JUNE 15, 1983

House of Representatives,
Committee on Ways and Means,
Washington, D.C.

The committee met at 9:30 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

[The press releases announcing the hearings follow:]

[Press release of Tuesday, May 24, 1983]

Hon. Dan Rostenkowski (D., Ill.), Chairman, Committee on Ways and Means, Announces Hearings on Trends in Municipal Financing and the Use of Tax-Exempt Bonds To Finance Private Activities

The Hon. Dan Rostenkowski, (D., Ill.), Chairman of the Committee on Ways and Means, U.S. House of Representatives, today announced that the Committee will hold hearings on trends in municipal financing and the use of tax-exempt bonds issued by State and local governments to finance private activities. In particular, the hearings will focus on H.R. 1176, which would repeal the December 3, 1983 sunset date for the issuance of mortgage subsidy bonds, and H.R. 1635, which would impose additional limitations on industrial development bonds. The hearing will be held on Tuesday, June 14, 1983, at 10:00 a.m., in the Committee's main hearing room, Room 1100, Longworth House Office Building, and will continue on Wednesday, June 15, 1983.

I. BACKGROUND

The volume of tax-exempt bonds issued by State and local governments to finance private activities has increased at an explosive rate during the last few years. As recently as 1975, the volume of long-term issues for such purposes was aboaut $5 billion. Last year, the volume was at least $41 billion and represented about one-half of the long-term tax-exempt bonds issued by State and local governments for all purposes. In 1975, private activity bonds represented only one-sixth of all tax-exempt bonds issued. The use of tax-exempt bonds to finance private activities has been an issue of Congressional concern in recent years because of their impact on the ability of State and local governments to finance traditional public purpose projects such as schools, streets and highways, sewer systems and transit facilities. In view of the massive deficits confronting the country, Congress has also been concerned about the erosion of Treasury receipts. Moreover, questions have been raised about the appropriateness of specific uses of tax-exempt bonds, whether any significant public purpose is served when subsidized financing is provided. Questions have also been raised about the efficiency of tax-exempt financing as a subsidy mechanism because the interest savings to the beneficiaries of tax-exempt financing are typically significantly less than the revenue loss to the Federal Treasury.

Private activity tax-exempt bonds are primarily of two types: industrial development bonds and mortgage subsidy bonds. In addition, tax-exempt bonds are issued to finance private, nonprofit hospitals and other tax-exempt entities, such as colleges and universities. Tax-exempt bonds are also used to finance loans for the benefit of students and their parents.

Industrial development bonds.—Industrial development bonds (IDBs) are obligations, the proceeds of which are used in the trade or business of a private firm. These bonds may only be issued on a tax-exempt basis for a specified list of activities (rental housing that includes units for low- or moderate-income individuals, airports, ports, sewage or solid waste disposal, pollution control, etc.) or for other purposes subject to the "small issue" limitation. Small issue IDBs can be used to acquire land or depreciable property (but with certain restrictions). These issues can be $1 million or less, without regard to the total capital expenditues for the facility, or up to $10 million if, in general, the capital expenditures associated with the facility do not exceed $10 million.

Limitations on IDBs were first imposed by the Revenue and Expenditure Control Act of 1968 and have been revised several times since. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) imposed new limitations on IDBs. TEFRA provided, with some exceptions, that property financed with IDBs must be depreciated over ACRS recovery periods on a straight-line basis. New procedures for public hearings and elected official approval for IDBs were introduced. New reporting requirements were introduced for all private activity tax-exempt bonds. Use of small issue IDBs for specific purposes was denied. In addition, small issue IDBs are to sunset after 1986. The maximum term of bond issues was limited to 120 percent of the expected useful life of the property being financed. Other provisions of TEFRA liberalized the issuance of IDBs in several respects.

Mortgage subsidy bonds.—Mortgage subsidy bonds (MSBs) are tax-exempt obligations, the proceeds of which are used to finance owner-occupied housing. Prior to 1978, very few MSBs were issued. In response to a very rapid increase in the issuance of MSBs beginning in 1978, legislation was enacted (The Mortgage Subsidy Bond Tax Act of 1980) to impose limitations on their issuance and terminate their use at the end of 1983. The limitations included a State-by-State cap on the annual volume of MSBs issued; use of MSB proceeds were in general limited to first-time homebuyers, who bought homes no more expensive than 90 percent of the average price of houses sold in their area. (This limit was increased to 110 percent by TEFRA.) On April 18, 1983, the General Accounting Office issued a preliminary report on its study of the costs and benefits of single-family mortgage revenue bonds to the Chairman of the Committee on Finance of the U.S. Senate. The GAO Report concluded that "the long term revenue loss to the Treasury could be roughly four times the benefit provided to homebuyers in the form of reduced monthly mortgage payments." The Report went on to point out that only "[a]bout 25 percent of revenue bond loan funds did go to low- or moderate-income households (those with less than 80 percent of median income)."

II. SCOPE OF THE HEARINGS

A. Trends in municipal financing.—The Committee seeks testimony on the impact of the growing volume of private-activity bonds on Federal receipts and on the ability of State and local governments to finance traditional public purpose projects. At a time when our States, cities, counties and school districts need to rebuild highways, expand and modernize sewer systems and rehabilitate older buildings, the committee is concerned that the market for tax-exempt bonds will be swamped by private activity issues to benefit firms that have adequate access to capital markets, commercial activities that take jobs away from established businesses, and projects that merely move jobs from one area to another.

B. Specific legislative proposals.—The hearings will include testimony on H.R. 1176 and H.R. 1635.

H.R. 1176 would repeal the December 31, 1983, sunset date on the issuance of tax-exempt bonds to finance owner-occupied housing. The bill makes no other changes in the provisions of the Mortgage subsidy Bond Tax Act of 1980 though the Committee invites testimony on its substantive provisions.

H.R. 1635 would require that depreciable property financed with IDBs, with the exception of low- or moderate-income rental housing, be depreciated on a straight-line basis over extended recovery periods: 5 years for 3-year property; 8 years for 5-year property; 15 years for 10-year property: 22 years for 15-year public utility property; and 25 years for 15-year real property. The bill restricts the use of "small issue" IDBs to those firms (including their subsidiaries) with total capital expenditures or a worldwide basis of less than $20 million during the 3-year period prior to issuance and for whom no more than $20 million of small issue IDBs would be outstanding after issuance of the bonds. Small issue IDB proceeds could not be used to acquire land. These provisions would become effective upon enactment. The Committee also invites testimony on other approaches to limiting the issuance of tax-exempt bonds for private activities. The Oversight Subcommittee made recommendations in this regard in 1981 upon which witnesses may wish to comment. In addition, some members have indicated their interest in exploring the concept of State-by-State volume limitations.

H.R. 1635 would also prohibit IDB financing where obligations are directly or indirectly guaranteed or insured by FDIC or FSLIC deposit insurance. This provision would be effective for obligations issued after April 14, 1983. On March 4, 1983, the Treasury Department announced its support of legislation to deny tax-exempt status to bonds that are guaranteed directly or indirectly by the FDIC or FSLIC. The Treasury Department also indicated its support of an April 15, 1983 effective date with an exception for bonds issued pursuant to a written commitment that was binding on March 4, 183, and at all times thereafter.

In announcing the hearings, Chairman Rostenkowski stated that: "I fully understand the popularity of IDBs at the local level. As long as the interest subsidies paid for by the Federal government can be given out without any direct cost being borne by the issuing government, there is little or no reason for IDBs to be issued with restraint or with some sense of public purpose priorities. There may be legitimate uses of IDBs, but these either need to be identified more clearly in the Internal Revenue Code, or State and local governments need to issue such bonds under effective volume limits.

"I am aware of the strong interest in repealing the sunset date for mortgage subsidy bonds. Supporters of that proposal should be prepared to address the findings of the recent GAO Report on housing bonds. Earlier this year, I called for a tax freeze—repeal of all of the tax cuts scheduled to go into effect in 1984 and future years—as a partial response to the massive deficits that face us during the latter half of the '80's. In my view, if mortgage subsidy bonds are to be extended, consideration should be given to an appropriately balanced legislative proposal both as to volume and revenue."

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD

Individuals and organizations interested in presenting oral testimony before the Committee must submit their requests to be heard in writing no later than Wednesday, June 8, 1983, to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. Notification to those scheduled to appear will be made by telephone as soon as possible after the filing deadline.

In view of the limited time available to hear witnesses, the Committee will not be able to accommodate all requests to be heard. Those persons and organizations not scheduled for an oral appearance will be encouraged to submit written statements for the record of the hearing. All persons requesting to be heard, whether they are scheduled for oral testimony or not, will be notified as soon as possible after the filing deadline.

It is urged that persons and organizations having a common position make every effort to designate one spokesperson to represent them in order for the Committee to hear as many points of view as possible. Time for oral presentations will be limited with the understanding that a more detailed statement may be included in the printed record of the hearing. This procedure will afford more time for members to question witnesses. In order to expedite the hearing, witnesses may be grouped as panelists with strict time limitations for each panelist.

Requests to be heard must contain the following information:

1. The name, full address, and capacity in which the witness will appear (as well as a telephone number where he or his designated representative may be reached);
2. A list of any clients or persons, or any organization for whom the witness appears; and
3. A topical outline or summary of comments and recommendations.

The above information should also be incorporated in the prepared statements to be presented in person as well as those filed for the written record of the hearing.

In order to assure the most productive use of the limited amount of time available to question witnesses, witnesses scheduled to appear before the Committee are required to submit 200 copies of their prepared statement to the full Committee office, room 1102 Longworth House Office Building, 24 hours in advance of their scheduled appearance.

The Committee wishes to emphasize that failure to comply with these requirements may result in the witnesses being denied the opportunity to testify in person.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE

For those who wish to file a written statement for the printed record of the hearing, six copies are required and may be submitted to the Committee office by the close of business Friday, June 17, 1983, to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, Room 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements for the record of the printed hearing wish to have their statements distributed to the press and the interested public, they may provide 100 additional copies for this purpose during the course of the public hearing.

[Press release of Thursday, June 9, 1983]

HON. DAN ROSTENKOWSKI (D., ILL.), CHAIRMAN, COMMITTEE ON WAYS AND MEANS, ANNOUNCES CHANGES IN DATES FOR HEARINGS ON TRENDS IN MUNICIPAL FINANCING AND THE USE OF TAX-EXEMPT BONDS TO FINANCE PRIVATE ACTIVITIES

The Honorable Dan Rostenkowski, (D., Ill.), Chairman of the Committee on Ways and Means, U.S. House of Representatives, today announced a change in the dates for the hearings previously announced on trends in municipal financing and the use of tax-exempt bonds issued by State and local governments to finance private activities. These hearings have been rescheduled for June 15 and 16. The hearings will begin each day at 9:30 a.m., in the Committee's main hearing room, Room 1100 Longworth House Office Building.

Chairman ROSTENKOWSKI. The committee will come to order.

I and many other members of this committee have been alarmed by the rapidly growing volume of tax-exempt bonds being issued to finance private activities. I was a member of this committee in 1968 when the first restrictions were placed on the issuance of industrial development bonds. At that time, we were concerned about volumes of industrial development bonds in the $1 and $2 billion range.

In 1982, the volume of the IDB's was at least $44 billion, more than half of all long-term tax-exempt bonds issued last year. This increase in volume has occurred despite the restrictions enacted in 1968. My concern is not only about the revenue loss to the Federal Government, but also the impact on State and local governments' borrowing costs for traditional purposes.

I am also concerned that bonds are being issued without any sense of public priorities. For example, in my own city of Chicago, IDB's were recently approved for a liquor store and luxury sky boxes for a sports stadium.

I am certainly aware of the interest in eliminating the sunset date on mortgage subsidy bonds. However, in view of the massive deficits confronting the Nation and this committee's responsibility in addressing those deficit problems, I feel that any elimination or extension of the mortgage bond sunset date should be accompanied by offsetting revenues, so that a balanced revenue package can be reported to the House of Representatives.

For that reason, I have scheduled these hearings on both H.R. 1176, which would repeal the sunset of mortgage subsidy bonds, and H.R. 1635, which would impose additional restrictions on IDB's. I invite witnesses to present testimony beyond consideration of these two specific bills, to discuss trends in the market for tax-exempt securities and alternative ways to limit the volume of private activity bond issues.

I am hoping that we can develop some legislative history so that we can both solve the problems of the private sector and Government tax policy.

Mr. Pickle is recognized.

Mr. PICKLE. Well, I thank you, Mr. Chairman, and I thank you for holding these hearings, because we are dealing with a subject that is extremely important to the American public.

Five years ago the interest rate on tax-exempt bonds was 65 percent of the interest rate on taxable bonds. Today it is only 85 percent of interest rates on taxable bonds. So of course, as this gap closes the cost of financing traditional public infrastructure, things like roads, and sewers, and waterlines, have been driven up. Local taxpayers have paid the price in higher property taxes and higher user fees.

There are, of course, a number of causes for the spiraling cost of public financing, but a significant factor has been the proliferation of private purpose tax-exempt issues. IDB's have bred like rabbits or stray cats in the last few years.

In 1975, the total dollar value of private purpose IDB's was $4.9 billion. By 1982, that figure was nearly $41 billion. When we dump this many private purpose bonds on the market, we not only create tax shelters for every doctor, and lawyer, or banker, or oil man, or undertaker, you name it, in the country, but we dry up funds for legitimate public needs and force up interest rates for State, county, and municipal governments.

Now, H.R. 1635 will not solve that problem completely, but it will at least make a start. The Joint Tax Committee estimates that all IDB financing under present law will cost us $10.1 billion in 1984. That figure jumps to $15 billion in 1988, a very conservative estimate.

We are just simply asking for a $100 million reduction for 1984 and an additional reduction in the next few years. Now, that does not seem like too much to ask to me. But we recognize there are many vested interests in maintaining the status quo with respect to IDB's. There are commissions, fees, and other considerations. But what we need to do today is try to separate the merits from the moaning. As we say in Texas, we have got to try to separate the pig from the squeal.

The Federal Government has many serious problems of its own, and we ought to avoid trying to help any major corporation or developer make Uncle Sam foot the bill for their private development project, and that is the purpose of these hearings. I commend the chairman for opening the hearings.

Chairman ROSTENKOWSKI. Mr. Downey is recognized.

Mr. DOWNEY. Thank you, Mr. Chairman.

I am delighted as well to see the hearings have commenced. If I could take a cue from my friend from Texas, the assumption is that all of these are pigs and some are squealing and some are not. I think in order for us to be fair we have to recognize that this use of tax-exempt financing for some purposes has been valid and has provided good economic results in communities around the country.

I think it would be a mistake to view this tax-exempt financing completely as a boondoggle and as a cost to the Treasury. I hope that the members, as we listen to the hearings, keep an open mind about the usefulness of tax-exempt financing.

Thank you.

Chairman Rostenkowski. Mr. Conable is unavoidably detained. However, Mr. Conable does have a statement which he asked be included in the record by unanimous consent.

[The prepared statement follows:]

Introductory Statement of Hon. Barber B. Conable, Jr., a Representative in Congress From the State of New York

Welcome to the Committee, Secretary Chapoton. It is always a pleasure to have your testimony.

I commend the Chairman for calling these hearings concerning trends in municipal financing and the use of tax-exempt bonds to finance private activities. The press release announcing the hearings identified many of the important considerations suggesting the importance of these hearings. I would like to highlight several.

First, the growth of private purpose, tax-exempt financing has been most startling in recent years, both in terms of its total volume, which has increased from $5 billion in 1975 to $41 billion in 1982, and in terms of the percentage which private purpose tax-exempt financing makes up the total of all tax-exempt bonds issued. In 1975, private purpose tax-exempt financing amounted to only one-sixth of all bonds issued, whereas last year it represented one-half of all long-term tax-exempt bonds. I am most concerned about the impact which this growth has had on the rate of interest paid by State and local governments for their own financing, because there has been a distinct narrowing of the interest rate for tax-exempt obligations as compared with taxable obligations. Thus, it would seem that the cost of borrowing to State and local governments has been increased as a result of the dramatic growth of the private purpose tax-exempt financing area.

Second, I have been somewhat concerned about the type of transaction whereby industrial development bond financing has been directly or indirectly guaranteed or insured by the FDIC or FSLIC (Deposit Insurance) Programs. One of the bills which is the subject of today's hearing, H.R. 1635, would address that issue. I understand that the Treasury generally supports the approach of the bill.

To the extent that the Committee considers it necessary to try and limit the growth of private purpose financing, I am hopeful that the witnesses will provide testimony, both with respect to the approach taken by H.R. 1635 and other approaches, such as the possible volume cap proposal referred to in the press release announcing the hearings. While I realize that these are proposals which are controversial in many respects. I think that it is important that the Committee recognize the impact which unrestrained growth can have, both on State and local governments and on the Federal Treasury.

Finally, it will be valuable for the Committee to obtain the views of the witnesses today concerning the merits of H.R. 1176 which would repeal the sunset date for the mortgage subsidy bond program. As we are all aware, this is a bill which has attracted many cosponsors in both the House and the other body.

Chairman Rostenkowski. Welcome to the committee, Mr. Chapoton. It is nice to have you with us. Perhaps we can work a little more closely today than we did yesterday.

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY

Mr. Chapoton. Thank you, Mr. Chairman. It is nice to be here. I am happy to have the opportunity to present our views on the two bills before you today.

As the chairman requested, I would also like to take this opportunity to discuss both our concerns about the growing volume of all types of private purpose tax-exempt bonds and to discuss various ways that this volume might be brought under control.

The tax-exempt market is often referred to as the municipal bond market, but that term has become something of a misnomer.

Since 1979, as the chairman mentioned, one-half of all long-term tax-exempt bonds issued have been for the direct benefit of private businesses, organizations or individuals, rather than for use by cities, States, or political subdivisions.

Private purpose bonds issued in 1975 totaled only $6 billion, accounting for only 20 percent of the long-term tax-exempt market. In 1982 private purpose bonds totaled $44 billion and accounted for 54 percent of the entire long-term tax-exempt market.

During the last decade, State and local governments and various quasi-governmental agencies they have created have turned to tax-exempt financing to accomplish expanded objectives, such as economic growth and housing. The growth of private purpose bonds can be attributed to a number of factors:

First, all borrowers, of course, searched for lower cost financing tools as interest rates have risen. But even with lower interest rates expected in the future, tax-exempt bonds will still offer a clear advantage. Thus, borrowers who have learned to use tax-exempt financing during times of high interest rates are unlikely to abandon the lower rates offered by tax-exempt financing in the future.

Second, most governments began issuing tax-exempt bonds for private activities as they observed their neighboring jurisdictions offering this Federal subsidy. The competition between States for economic development eventually forced all States to begin offering IDB's. Tax-exempt financing could be offered to private businesses and individuals at little or no cost to the issuer. Arbitrage profits and fees could defray any administrative costs and could sometimes earn a profit for the issuer.

There are still some States which have not issued certain types of private purpose bonds or have done so only in limited amounts, so the potential for growth remains very large.

Finally, some of the increased private purpose bond activity may be attributed to reductions in direct expenditures or loan guarantees by the Federal Government. For example, the growth in private hospital bond volume in the mid-1970's was partially due to the cutback of the Hill-Burton program, which provided Federal funds for hospital construction.

Tax-exempt financing has been a backdoor means of obtaining Federal subsidies, usually without explicit congressional approval and sometimes in direct contravention of Federal budget policies. Further cuts in direct expenditure and credit programs would increase the pressure for expanded use of private purpose tax-exempt bonds.

We think that Congress should act now to limit the growth of private purpose tax-exempt financing. There is every reason to believe that growth will continue after further restrictions. There are a number of reasons why Congress should take meaningful steps to limit the growth:

First, the enormous growth of private purpose tax-exempts has damaged the traditional tax-exempt market by exerting upward pressure on tax-exempt rates. Higher interest rates increase the cost of State and local governments financing traditional public projects and thus may cause reductions in public services or increases in State and local taxes.

Second, private purpose tax-exempt financing is an inherently inefficient means of providing subsidies to the intended beneficiaries. At least one-third of the benefit of tax-exempt financing generally is captured by the financial institutions and other investors who hold tax-exempt bonds. This is hardly a cost effective ratio for a subsidy program.

Third, long-term tax-exempt bonds result in substantial present and future revenue losses. Private purpose tax-exempt bonds will reduce tax revenues by at least $5.8 billion in this fiscal year, the current fiscal year. Tax-exempt bonds produce a revenue loss not only in the year of their issuance, of course, but also in each year that they remain outstanding.

The fourth reason is that private purpose tax-exempt financing is often used by private businesses and individuals who would not receive direct assistance from either the Federal Government or the State or local government. Examples include IDB's issued for high income professionals and large publicly held corporations and mortgage subsidy bonds to finance mortgages for families in the top half of their State's income distribution. The Federal Government cannot afford to provide indiscriminate subsidies in these times of budgetary constraint.

Finally, the growth of private purpose tax-exempt financing frustrates development of a coherent Federal budget policy. Tax-exempt financing is being used as a substitute for direct Federal subsidies. Much of the savings to the Federal Treasury from reducing direct expenditures is lost when Federal subsidies are obtained through the backdoor means of tax-exempt financing.

Congress and the Treasury have repeatedly considered various limitations on private purpose tax-exempt financing. One approach has been, and which is often discussed, to limit tax-exempt financing to specific types of activities that are believed to serve a public purpose or to particular beneficiaries who are thought to be worthy of a subsidy.

In 1981 the Ways and Means Oversight Committee, for example, proposed to limit small issue IDB's to industrial facilities, as opposed to commercial projects, except in targeted areas. This was an example of distinguishing between good and bad private purpose bonds.

But it is difficult for the Federal Government to determine what type of activity best serves local needs. Proponents in that case argue that only industrial activities produce a net increase in jobs for a locality. Others contended, however, that a job is a job regardless of whether it is in an industrial or commercial position, and they of course point to examples of successful urban economic redevelopment centered around commercial projects.

Another approach to limiting the growth of tax-exempt private purpose financing is to require that issuers exercise greater responsibility in determining whether a project to be financed with tax-exempt bonds serves a significant public purpose. Congress took a step towards a local public purpose requirement in TEFRA by enacting the administration's proposal to require that all IDB's issued be approved by a voter referendum or an elected public official following a public hearing.

Congress did not go as far as we have suggested, however. We would have required that the locality make some financial contribution or commitment to an IDB-financed project as a tangible demonstration that it is deserving of subsidization.

A third approach that has been tried in the past is to reduce the total incentive for users and issuers of private tax-exempts. The combination or double-dipping of ACRS and in some cases the investment tax credit and rehabilitation tax credits with tax-exempt financing can produce substantial negative tax rates. This negative tax can shelter not only the income from the IDB-financed property, but also other income as well.

To deal with this double-dipping problem, the administration proposed last year that IDB-financed property be depreciated on a straight-line basis over extended recovery periods. TEFRA adopted a partial approach that did not go as far as the administration had proposed in lengthening the lives over which IDB-financed property must be depreciated, however.

Unfortunately, the limitations adopted in the past have not curtailed the flood of private purpose bonds and experience leads us to conclude that it will be very difficult for Congress to make significant inroads on the growth of private purpose tax-exempts by pursuing past approaches. Thus, we believe that new approaches deserve serious consideration by the Congress. We believe that new approaches are essential if Congress decides to extend the sunset date for mortgage subsidy bonds.

One new approach would be to impose State volume limitations on all private purpose tax-exempt bonds. Mortgage subsidy bonds are now subject to State volume limitations, but other private purpose bonds are not. Under a comprehensive State volume limitation, all private purpose tax-exempts would be aggregated and would be subjected to a maximum level for each State.

State and local governments would then be able to decide which qualifying activities best serve local needs. The Federal interest would be protected because the overall limit on the amount of private tax-exempt financing would be imposed on the amount that could be issued.

We believe that a State volume cap on all types of private purpose bonds can be made to work, although we recognize there would be difficulties in designing it. We would support a properly designed State volume limitation if the limitation imposes a reasonable ceiling on the amount of private purpose bonds that can be issued. Adopting a comprehensive limitation of this type becomes even more important, as I have Stated, if Congress decides to extend the sunset for mortgage subsidy bonds.

Another alternative that deserves careful consideration is providing direct Federal assistance through tax credits or other means as a substitute for private purpose tax-exempt financing for certain activities. If Federal subsidies are provided directly through tax credits or other means in lieu of tax-exempt financing, a larger share of the benefits will inure to the intended beneficiaries. If desirable, direct subsidy programs could be designed to use the same eligibility criteria and the same State and local government administrative systems as the tax-exempt bond programs they replace.

With this background, Mr. Chairman, let me now discuss the two bills before the committee at this hearing. These bills move in opposite directions with respect to private purpose tax-exempts. One limits the issuance of IDB's and the other extends the time over which mortgage subsidy bonds could be issued.

H.R. 1176 would repeal altogether the sunset on the issuance of mortgage subsidy bonds, due to take effect at the end of this year. It would thus make permanent the tax-exemption presently provided for qualified mortgage bonds.

The administration supports the sunset and thus we strongly oppose H.R. 1176. We think that the mortgage subsidy bonds are not a cost effective way for the Federal Government to subsidize home ownership. Moreover, we believe that the subsidies that MSB's provide to homeowners are unnecessary in view of other Federal assistance for low- and moderate income home buyers.

We also oppose extension of the sunset because it would further damage the tax-exempt market and would have a serious impact on the Federal revenue. The additional volume of mortgage subsidy bonds that would be issued in 1984 if the sunset were extended would increase the total interest payments on public purpose bonds issued in 1984 by at least $600 million. Moreover, the mortgage subsidy bonds issued in 1984 would be outstanding in later years and thus would also increase by roughly the same amount the interest costs on public purpose bonds issued in future years.

Extension of the mortgage subsidy bond program would also cause enormous future Federal revenue losses. A 1-year extension would have a total cost over the life of the bonds issued in just 1984 of $4 billion to the Federal Treasury. A 3-year extension would have a total cost of $15 billion over the period the bonds would be outstanding.

We, of course, recognize that, notwithstanding our objection to extending the sunset, there is considerable congressional support for extending the MSB program, and we want to point out that if the mortgage subsidy bond program is to be continued, Congress should attempt to limit the damage to the tax-exempt market and to offset future revenue losses by simultaneously placing further restrictions on other private purpose tax-exempts.

Also, any extension of the existing mortgage subsidy bond program should modify the existing program to target the benefits to low- and moderate income first-time home buyers. TEFRA expanded the eligibility for tax-exempt mortgage subsidy bond assistance to existing home buyers in nontargeted areas. The mortgage subsidy bond program, if continued, should be restricted to first-time home buyers in nontargeted areas.

TEFRA also increased the purpose price limit from 90 percent to 110 percent of the average area purchase price. The General Accounting Office found that even before these changes made in TEFRA, over half of the beneficiaries of the mortgage subsidy bond program were in the top half of the income distribution of their States. If the program is continued, we think it should be targeted to low- and moderate-income first-time home buyers.

The original mortgage subsidy bond legislation permitted higher purchase price limits and did not impose the first-time home buyer requirement in the case of certain targeted areas, including areas of chronic economic distress. States are permitted to designate within their boundaries areas of chronic economic distress according to four subjective criteria.

As a result, some States have designated more than half of their entire population as living in chronic economically distressed areas. We think these criteria should be tightened and made more objective if the program is to continue.

We would also point out that the State volume limitation on mortgage subsidy bonds, that is the greater of $200 million or 9 percent of the preceding 3-year average of mortgage originations in the particular State, should be reviewed. Our estimate is that under those criteria, allowable bond volume will increase from $14 billion in 1984 to $23 billion in 1987 and $31 billion of mortgage subsidy bonds issued in 1990. It is unlikely that this enormous volume of single family mortgage bonds can be issued without serious damage to the tax-exempt market and the Federal Treasury.

Finally, we would point out that a permanent extension of the mortgage subsidy bond program would permit the program to continue without assurance that its usefulness or effectiveness would be reviewed in the future. Sunset provisions do perform an important function in that they force congressional review of a tax subsidy from time to time, and we would think that if the program should be continued, it should be for a specific time period rather than a permanent extension.

Turning to H.R. 1635 briefly, Mr. Chairman, it would impose additional limits on industrial development bonds. In general, we support H.R. 1635. We think that, as I have said, that additional limits on IDB's are particularly important if the mortgage subsidy bond program is to be extended.

H.R. 1635 would require cost recovery on property financed with IDB's, except for certain low- and moderate-income rental housing projects, to be determined under the straight-line method over an extended recovery period. These changes do not go as far as our proposal would have last year, but we do strongly support this provision of the bill.

Section 3 of H.R. 1635 would further restrict small issue IDB's. No business with more than $20 million of worldwide capital expenditures during a 3-year period would be eligible to issue small-issue IDB's, and a business could be entitled to have no more than $20 million outstanding at any one time. Also, small issue IDB's could no longer be used to finance land.

We support these changes in an attempt to limit small issue IDB's to small business. We think these changes would have that effect and are desirable.

Finally, under a separate section of H.R. 1635, or a subsection of that bill, it deals with the particularly egregious abuse that combines tax-exempt IDB's with Federal insurance by FSLIC or FDIC through deposits in banks or thrifts. Under current law, a State or local government obligation may qualify for tax-exempt status if the proceeds are deposited with a financial institution under a loans-to-lenders program and then reloaned to customers of the financial institution for projects qualifying for tax-exempt financing. Thus, State and local governments can, through this mechanism of deposits in federally insured institutions, obtain both the dual benefits of tax-exemption and a Federal guarantee.

Section 2 of H.R. 1635 would simply deny tax-exempt status to IDB's that are backed by Federal deposit insurance. This is similar to S. 1061, a bill introduced by Senator Dole at the request of the administration. We strongly support a change prohibiting tax-exempt bonds from being insured by FDIC or FSLIC. It does allow these obligations to have a competitive advantage over all other tax-exempt obligations issued by State and local governments, and that means that these outstanding bonds, which have been issued in a significant dollar amount, will raise the cost of borrowing to Federal, State, and local governments.

This is also inconsistent with established Federal policy against Federal guarantees of tax-exempt obligations.

We would point out that on March 4, the administration proposed an effective date on our bill of April 15. That is, such bonds issued after April 15 could not receive tax-exemption. The April 15 date was designed to allow bonds already in the pipeline to be issued without hardship.

But facts have developed and have come to our attention since that date indicating that the April 15 date may well have been too generous. One tax news service reported that on March 29, a single bond-rating agency had pending requests to provide ratings on $4 billion of these obligations involving about 400 issuers and 600 separate bond issues. This type of report makes it clear why this legislation is needed and why the April 15 effective date must be retained.

Finally, we would point out that, while the bill before you applies only to industrial development bonds, we think the limitation should apply to all tax-exempt bonds. The policy reasons against federally guaranteed tax-exempt bonds apply equally to IDB's and other tax-exempt bonds, and that is what the Senate bill provides, and we would suggest that the committee follow that route.

Thank you, Mr. Chairman. I apologize for taking a little longer time.

[The prepared statement follows:]

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY (TAX POLICY), DEPARTMENT OF THE TREASURY

Mr. Chairman and Members of the Committee: I am pleased to have the opportunity to present the views of the Treasury Department on H.R. 1176, which would eliminate the December 31, 1983 sunset on the tax exemption provided for interest on certain mortgage subsidy bonds ("MSBs"), and H.R. 1635, which would impose additional limitations on industrial development bonds ("IDBs") and would deny tax-exempt status to IDBs that are guaranteed by Federal deposit insurance. In addition to commenting on these two bills, I would like to take this opportunity to discuss both our concerns about the growing volume of all types of private purpose tax-exempt bonds and various ways that this volume might be brought under control.

THE GROWTH OF PRIVATE PURPOSE TAX-EXEMPT FINANCING

The tax-exempt bond market often is referred to as the municipal bond market. Due to the recent explosive growth of private purpose tax-exempt bonds, the term "municipal bond" has become a misnomer. Since 1979, over one-half of all long-term tax-exempt bonds issued have been for the direct benefit of private businesses, organizations, or individuals, rather than for use by cities, States or their political subdivisions.

Chart 1 shows the change that has occurred in the long-term tax-exempt bond market during the past 8 years. Private purpose bonds issued in 1975 totalled only $6 billion, accounting for 20 percent of the long-term tax-exempt bond market. In 1982, private purpose bonds totalled $44 billion and accounted for 54 percent of the tax-exempt market. These figures include only the major types of private purpose bonds that could be identified and thus understate the total volume of private purpose bonds. Chart 2 breaks down further the private and public purpose uses of bonds issued in 1982. Bonds issued for public schools, water and sewer systems, and highways and bridges—which are the only types of traditional public purpose bonds that we have been able to identify based on data currently available—totalled only $10.3 billion, compared to the $44 billion of private purpose bonds.

During the last decade State and local governments, and various quasi-governmental agencies that they have created or authorized, have become increasingly interested in promoting economic development and housing in their jurisdictions. These governmental units and their agencies have turned to tax-exempt financing to accomplish their expanded objectives. The volume of different types of private purpose tax-exempt financing in recent years is shown on Table 1. The table shows the following:

Pollution control bonds, multi-family rental housing bonds, and private hospital bonds were the main private uses of tax-exempt financing in the early 1970's. Their use has grown steadily from $4.5 billion in 1975 to $18.4 billion in 1982.

Small issue IDBs began growing rapidly in 1978–79 as more States became interested in promoting economic development. Small issue IDBs totalled $1.3 billion in 1975 and grew to an estimated $14.7 billion in 1982.

MSBs for owner-occupied homes became widely used in 1977. MSBs grew from $1 billion to $10.5 billion in less than three years.

The most rapid recent growth has been in student loan bonds, which grew from $0.5 billion in 1980 to $1.8 billion in 1982.

Because of the limited information available with respect to private purpose bonds issued before 1983, a significant volume of other types of private purpose bonds cannot be identified. These bonds thus are hidden among the statistics in the category of "other long-term tax exempts" on the table.

The total amount of private purpose tax-exempt bonds is not known exactly. The reporting requirement enacted as part of TEFRA will provide much needed information about the volume and uses of private purpose bonds. Information for the first calendar quarter of 1983 is being processed and will be made available to this Committee in the near future. The reporting requirement, however, does not cover many types of private purpose bonds, such as mortgage subsidy bonds, veterans' housing bonds, housing bonds authorized under Section 11(b) of the Housing Act of 1937, and private purpose bonds issued by Puerto Rico, other territories and the District of Columbia.

The growth of private purpose bonds can be attributed to a number of factors. First, all borrowers searched for lower cost financing tools as interest rates rose. It is possible that this impetus for tax-exempt financing may decrease as interest rates fall. Nevertheless, even with lower interest rates, tax-exempt bonds still offer a clear advantage. Thus, borrowers who learned to use tax-exempt financing during times of high interest rates are unlikely to abandon them in the future.

Second, more governments began issuing tax-exempt bonds for private activities as they observed their neighboring jurisdictions offering this Federal subsidy. For instance, only seven States had issued student loan bonds before 1978. Five years later, thirty States had issued such bonds. Likewise, the competition between States for economic development eventually forced all States to begin offering IDBs. This was especially true when tax-exempt financing could be offered to private businesses and individuals at little or no cost to the issuer. Arbitrage profits and fees could defray any administrative costs and often could earn a profit for the issuer. There are still some States which have not issued certain types of private purpose bonds or have done so only in limited amounts, so the potential for growth remains large.

Given this state of affairs, the pressures on State and local governments to issue tax-exempt bonds for qualifying private activities are easy to understand. A jurisdiction wishing to persuade a business to construct a facility within its boundaries must be willing to offer tax-exempt financing in order to compete with other jurisdictions. Moreover, once a jurisdiction provides tax-exempt financing for one business within its boundaries, it is hard pressed to deny similar assistance to other businesses. Since virtually all costs are borne by the Federal government, it is very difficult for a State or local government to deny the Federal subsidy to anyone who seeks it.

Finally, some of the increased private purpose bond activity may be attributable to reductions in direct expenditures or loan guarantees by the Federal government. The growth in private hospital bond volume in the middle 1970's was partly due to the cutback of the Hill-Burton program which provided Federal funds for hospital construction. The recent blossoming of student loan bonds is due in part to the tightening of income eligibility requirements for Federally guaranteed student loans. Thus, tax-exempt financing has been a backdoor means of obtaining Federal subsidies, usually without explicit Congressional approval and sometimes in direct contravention of Federal budget policies which gave rise to cuts in direct expenditures or loan guarantees. Further cuts in direct expenditure and credit programs will increase the use of private purpose tax-exempt bonds.

REASONS FOR RESTRICTIONS ON PRIVATE PURPOSE TAX-EXEMPT BONDS

Congress should act now to limit the growth of private purpose tax-exempt financing. The amount of private purpose bonds is still increasing at a rapid rate. Because of the factors just discussed, there is every reason to believe that this growth will continue absent further restrictions. There are a number of strong reasons why Congress should take meaningful steps to limit the growth of private purpose tax-exempt bonds.

First, the enormous growth of private purpose tax-exempt bonds has damaged the traditional tax-exempt bond market by exerting upward pressure on tax-exempt interest rates. The percentage spread between long-term taxable and tax-exempt interest rates is now only 20 percent, compared to historical spreads of 30 to 35 percent. Higher tax-exempt interest rates increase the costs of State and local governments in financing traditional public projects such as roads, sewers and schools, and thus may cause reductions in public services or increases in State and local taxes.

Second, private purpose tax-exempt financing is an inherently inefficient means of providing subsidies to the intended beneficiaries. In determining the efficiency of the tax-exempt financing subsidy, the interest cost savings to the qualifying borrowers must be compared to the revenue loss to the Federal government from the additional tax-exempt income in the system. Studies show that for every $2 of interest cost savings to the party who uses the tax-exempt bond proceeds, the Federal government usually foregoes more than $3 of the tax revenues. In other words, at least one-third of the benefit of tax-exempt financing generally is captured by the financial institutions and other investors who hold tax-exempt bonds. This is hardly a cost-effective ratio for a subsidy program.

Third, long-term tax-exempt bonds result in substantial present and future revenue losses. Private purpose tax-exempt bonds will reduce tax revenues by at least $5.8 billion in this fiscal year. Tax-exempt bonds produce a revenue loss not only in the year of their issuance, but also in each year that they remain outstanding. For example, the annual revenue loss that would result from extending the MSB program through 1984 would be approximately $250–300 million, but the total revenue loss over the life of the additional MSBs issued in 1984 would be $4 billion.

Fourth, private purpose tax-exempt financing is often used by private businesses and individuals who would not receive direct assistance from either the Federal or State governments. Examples include small issue IDBs issued for high income professionals and large publicly held corporations, and MSBs to finance mortgages for families in the top half of their State's income distribution. The Federal government cannot afford to provide indiscriminate subsidies in these times of budgetary constraint.

Finally, the growth of private purpose tax-exempt financing frustrates development of a coherent Federal budget policy. Tax-exempt financing is being used as a substitute for direct Federal subsidies, direct loans, and loan guarantees, often after direct subsidy and credit programs have been eliminated or curtailed. Thus, much of the savings to the Federal Treasury from reducing direct expenditures is lost when Federal subsidies are obtained through the backdoor means of tax-exempt financing.

APPROACHES FOR CONTROLLING THE VOLUME OF PRIVATE PURPOSE TAX-EXEMPT FINANCING

Congress and the Treasury repeatedly have considered various limitations on private purpose tax-exempt financing. One approach has been to limit tax-exempt financing to specified activities that are believed to serve a "public" purpose or to particular beneficiaries who are thought to be worthy of a subsidy. For example, the original restrictions on IDBs enacted in 1968 included a lengthy list of particular "exempt" activities that could be financed with IDBs. This approach also was followed in the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), when

Congress restricted the availability of the small issue IDB exemption in the case of facilities the primary purpose of which is retail food and beverage services, automobile sales or services, or provision of recreation or entertainment. Anti-abuse approaches like the TEFRA small issue IDB limitation affect only a relatively small volume of private purpose bonds. Furthermore, the lines drawn between facilities that qualify and those that do not often are arbitrary.

The proposal by the prior Administration in its fiscal year 1982 budget to eliminate tax-exempt student loan bonds and bonds for private nonprofit institutions, and the 1981 Ways and Means Oversight Subcommittee proposal to limit small issue IDBs to "industrial" facilities as opposed to "commercial" projects (except in targeted areas), are other examples of proposals that attempted to distinguish between "good" and "bad" private purpose bonds. Reactions to the Oversight Subcommittee proposal illustrate how difficult it is for the Federal government to determine what type of activities best serve local needs. Proponents of the proposal argued that only industrial activities produce a net increase in jobs for a locality, whereas commercial activities do not, absent an industrial base. Others contended that a "job is a job" regardless of whether it is an industrial or commercial job, and they pointed to examples of successful urban economic redevelopment centered around commercial projects.

Another approach to limiting the growth of tax-exempt private purpose financing is to require that issuers exercise greater responsibility in determining whether a project financed with tax-exempt bonds serves a significant public purpose. Congress took a first step towards a "local public purpose" test in TEFRA by enacting the Administration's proposal to require that all IDBs be approved by a voter referendum or by an elected official following a public hearing. Congress did not enact, however, a second Administration proposal which would have required issuers to make some financial contribution or commitment to an IDB-financed project as a tangible demonstration that a local public purpose is served by the subsidized activity.

A third approach that has been tried in the past is to reduce the total incentives for users and issuers of private purpose tax-exempt bonds. Prior to TEFRA, property financed with IDBs was eligible for cost recovery deductions under the accelerated cost recovery system ("ACRS") adopted in 1981. The combination, or "double dipping," of ACRS (and in some cases investment and rehabilitation tax credits) with tax-exempt financing produced a substantial negative tax in some cases. This negative tax could shelter not only the income from the IDB-financed property, but other income as well. To deal with the double dipping problem, the Administration's proposal last year would have required IDB-financed property to be depreciated on a straight-line basis over extended recovery periods. However, in TEFRA, Congress did not go as far as the Administration proposed. Although TEFRA reduced the benefit of tax-exempt financing somewhat by requiring IDB-financed property to be depreciated on a straight-line basis, the property still may be depreciated over the relatively short ACRS lives. In addition, several types of IDB-financed property are completely exempt from the straight-line depreciation requirement. Congress in TEFRA also failed to adopt another Administration proposal which would have decreased the incentives to use tax-exempt financing by eliminating the ability of issuers to earn unlimited arbitrage profits on reserve funds and during temporary construction periods.

Unfortunately, the limitations adopted in the past have not curtailed the flood of private purpose tax-exempt bonds. It is possible that some reduction in the growth of private purpose bonds may be achieved by imposing further restrictions on the types of property that may be financed or on the total incentives for bond users and issuers. Nevertheless, experience leads us to believe that it will be very difficult for Congress to make significant inroads on the growth of private purpose bonds by pursuing past approaches. Thus, we believe that new approaches deserve serious consideration by Congress. We believe that consideration of these new approaches is essential if Congress decides to extend the sunset date of MSBs.

One new approach would be to impose State volume limitations on *all* private purpose tax-exempt bonds. MSBs are now subject to State volume limitations, but other private purpose bonds are not. Under a comprehensive State volume limitation, all private purpose tax-exempt bonds issued by or on behalf of the governmental units within each State would be aggregated and subjected to a maximum limit for the State. State and local governments then would be able to decide which qualifying activities best serve local needs. The Federal interest would be protected because of the overall limit on the amount of private purpose tax-exempt financing that could be issued.

Imposing State volume limits presents difficult political issues such as how to determine the limits and how to allocate the limits between State and local governments. Nevertheless, we believe that a State volume limitation on all types of private purpose bonds can be made to work. Treasury would support a properly designed State volume limitation if the limitation imposes a reasonable ceiling on the amount of private purpose bonds that can be issued. Adopting a comprehensive limitation of this type becomes even more important if Congress decides to extend the sunset date for MSBs.

Another alternative that deserves careful consideration is providing direct Federal assistance, through tax credits or other means, as a substitute for private purpose tax-exempt financing for certain activities. If Federal subsidies are provided directly through tax credits or other means in lieu of tax-exempt financing, a larger share of the benefits will inure to the intended beneficiaries. Direct assistance also would bypass the intermediaries who now reap a substantial portion of the benefits of tax-exempt financing. The rate of a direct subsidy could be set directly by Congress and would not be subject to conditions in the volatile tax-exempt bond market. Moreover, the subsidy could be limited to the period in which it is needed, rather than being extended for the entire life of a tax-exempt bond. If desirable, direct subsidy programs could be designed to use the same eligibility criteria and State and local government adminstrative systems as the tax-exempt bond programs they replace.

I will now discuss the two bills before the Committee at this hearing. These bills move in opposite directions with respect to private purpose tax-exempt bonds. The first bill, H.R. 1176, would remove the sunset scheduled after 1983 for MSBs, which are responsible for a large share of the growing volume of private purpose tax-exempt bonds. The other bill, H.R. 1635, would impose a number of additional restrictions on tax-exempt IDBs.

H.R. 1176—ELIMINATION OF THE 1983 SUNSET ON TAX EXEMPTION FOR QUALIFIED MORTGAGE BONDS

H.R. 1176 would repeal the sunset provision in Code section 103A that denies the tax exemption for interest on qualified mortgage bonds issued after December 31, 1983. Thus, the bill would make permanent the tax exemption presently provided for qualified mortgage bonds.

Reasons for opposing tax-exempt mortgage subsidy bonds

The Administration supports the December 31, 1983 sunset of the MSB program and thus strongly opposes H.R. 1176. MSBs are not a cost-effective way for the Federal government to subsidize home ownership. Moreover, we believe that the subsidies that MSBs provide to homeowners are unnecessary in view of other Federal assistance for low- and moderate-income homebuyers.

We also oppose extension of the MSB sunset because it would cause further damage to the tax-exempt bond market and large Federal revenue losses. Extension of the MSB program would increase significantly the volume of private purpose tax-exempt bonds after 1983. A one-year extension would allow $13.7 billion of MBSs to be issued in 1984 and a three-year extension would permit an additional $49.6 billion of MSBs. This additional volume of tax-exempt bonds will increase substantially the interest costs for State and local governments in financing traditional public projects. The additional volume of MSBs that would be issued in 1984 would increase the total interest payments on public purpose bonds issued in that year by at least $600 million. The MSBs issued in 1984 would still be outstanding in later years, and thus would also increase by roughly the same amount the interest cost on future public purpose bonds as long as the MSBs are outstanding. Extension of the MSB program also would cause enormous future Federal revenue losses. A one-year extension would have a total cost of $4 billion to the Federal government. A three-year extension would have a total cost of $15 billion.

Changes needed if MSBs are extended

We recognize that notwithstanding the Administration's strong opposition to MSBs, there is considerable Congressional support for extending the MSB program as a means of providing additional Federal Assistance to homebuyers. If MBSs must be continued, Congress should attempt to limit the damage to the tax-exempt bond market and to offset the future revenue losses by simultaneously placing further restrictions on the other private purpose tax-exempt bonds. Moreover, at a minimum, the information reporting and public approval requirements that TEFRA made applicable to other private purpose bonds should be extended to MSBs. Additionally, any extension of the existing MSB program should modify the existing program to target the benefits to low- and moderate-income first-time homebuyers.

TEFRA expanded eligibility for tax-exempt MSB assistance to existing homeowners in nontargeted areas. Proponents argued that this change was needed because the recession and high interest rates made it difficult for State and local housing agencies to issue MSBs up to State volume limits without extending the program to individuals who already owned their own homes. With the robust housing recovery, however, we expect many issuers to reach the maximum allowable volume levels without difficulty. This means that a portion of the subsidized mortgage funds that otherwise would benefit first-time homebuyers will go to existing homeowners instead. The MSB program, if continued, should be restricted to first-time homebuyers in nontargeted areas.

TEFRA also increased the purchase price limits from 90 percent to 110 percent of the average area purchase price (and from 110 percent to 120 percent in targeted areas). This allows nearly all first-time homebuyers to qulify for MSBs. Certainly not all first-time homebuyers need Federal assistance to purchase a home. The General Accounting Office (GAO) found that even before the 1982 changes over one-half of the beneficiaries were in the top half of the income distribution of their States. The GAP study also found that only 25 percent of the MSB proceeds were provided to low- and moderate-income homebuyers, that is, families with incomes below 80 percent of the Stae median income. The MSB program, if continued, should be targeted to low- and moderate-income first-time homebuyers. In addition, the purchase price limitations should be based on area median prices, rather than average prices. Median prices are currently estimated for the FHA insurance program and would be a simpler and more reliable point of reference for the issuance involved.

The 1980 Act permitted higher purchase price limits and did not impose the first-time homebuyer requirement for eligibility in certain areas, including areas of "chronic economic distress." States can designate areas within their boundaries as areas of chronic economic distress according to four subjective criteria. The absence of objective criteria for the determination of such targeted areas has resulted in substantial administrative difficulties at both the State and Federal levels. Some States have designated more than one-half of their population as living in areas of chronic economic distress. We believe that the targeted area criteria should be tightened and made more objective if MSBs are continued.

The present State volume limitation on mortgage subsidy bonds allows States to issue the greater of $200 million or nine percent of the preceding three-year average of mortgage originations in the State. As the economy improves, we estimate that the total allowable bond volume will increase sharply from $14 billion in 1984 to $23 billion in 1987 and $31 billion in 1990. It is unlikely that this enormous volume of single-family mortgage bonds can be issued without serious damage to the tax-exempt bond market or the Federal Treasury. If MSBs are continued, the State volume limitation formula should be amended to take into account a lower percentage of mortgages originated in the State in the previous three-year period.

The current exemption of interest on general obligation bonds for veterans' housing should be reexamined as part of the overall review of tax-exempt financing for owner-occupied housing. Veterans' housing bonds do not have first-time homebuyer restrictions, purchase price limits or volume limitations. Additional eligibility criteria and inclusion of veterans' housing bonds under the MSB State volume limitations should be strongly considered if MSBs are continued.

Finally, a permanent extension of MSBs would permit this program to continue without assurance that its usefulness or effectiveness would be reviewed in the near future. Unlike direct expenditure programs, tax subsidies are not reviewed annually as part of the appropriations process. Sunset provisions serve an important function in that they force Congress to review the tax subsidy and, ideally, require proponents of the program to justify the public purpose of the subsidy and its cost-effectiveness. If the MSB program must be continued, we believe strongly that the extension should be for a specific time period rather than a permanent one.

H.R. 1635—INDUSTRIAL DEVELOPMENT BOND LIMITATION ACT

H.R. 1635 would impose additional limitations on IDBs and would prohibit a particularly egregious abuse that combines tax-exempt IDBs with Federal insurance by the FSLIC or FDIC on deposits in banks and thrift institutions. In general, Treasury strongly supports H.R. 1635. We believe that additional restrictions on IDBs are particularly needed if the MSB program is to be extended.

Further limitations on certain IDBs

Section 1 of H.R. 1635 would amend Code section 168(f)(12) to require cost recovery of all property financed with IDBs (except for certain low- and moderate-income rental housing projects) to be determined under the straight-line method over extended recovery periods. The recovery periods are not as long as those proposed in the Administration's 1982 proposal, which would have been based on the lives used for "earnings and profits" computation purposes. Furthermore, the Administration's proposal would have applied to all IDB-financed property without exception. Even though the proposed changes do not go as far as our proposal last year, Treasury strongly supports Section 1 of the bill.

As stated earlier, TEFRA limits cost recovery for IDB-financed property to straight-line cost recovery over the short ACRS recovery lives. ACRS deductions remain available for certain IDB-financed low-income rental housing, sewage and solid waste facilities, air and water pollution facilities, and facilities that receive a "UDAG" grant from the Department of Housing and Urban Development. Although most IDB-financed property is subject to the straight-line cost recovery requirement under present law, the combination of tax benefits provided through cost recovery and tax-exempt financing could in some cases still result in negative tax rates. Further restrictions on the full availability of both of these Federal tax benefits would make the after-tax cost of capital for businesses using ACRS without IDB financing more nearly equal to the cost of capital for those using IDB financing with reduced ACRS benefits. Tax-exempt financing would still be attractive for projects for which interest costs rather than cost recovery deductions are a dominant concern.

Section 3 of H.R. 1635 also would further restrict small issue IDBs. No business with more than $20 million of worldwide capital expenditures during the 3 years prior to issuance of the bonds would be eligible for the small issue exemption, and a business would be entitled to have no more than $20 million in small issue IDBs outstanding at any one time. In addition, small issue IDBs no longer could be used to finance land. Both of these changes would only apply through 1986 at which time the exemption for small issue IDBs is scheduled to sunset. Treasury strongly supports the proposed changes designed to limit small issue IDBs to "small business", which are similar to proposals made by the Administration last year. We also support the exclusion for financing of land. The restriction of small issue IDBs to businesses with less than $20 million of worldwide capital expenditures is a reasonable means to assure that the small issue subsidy is available only to businesses that are less likely to have access to other sources of low cost capital. Under present law, the subsidy is available to every company, no matter how large, for up to $10 million of capital expenditures in each city or county. The prohibition against small issue financing of land and the $20 million per issuer limitation will aid in reducing excessive use of the subsidy by some taxpayers and in controlling future growth of small issues.

FDIC and FSLIC insurance of IDB's

Under current law, State or local government obligations that are classified as IDBs do not qualify for tax-exempt status unless their proceeds are used for certain purposes specified in Internal Revenue Code section 103(b). If the proceeds of an issue of State or local government obligations are simply placed on deposit with a bank, savings and loan association or other financial institution, the obligations generally will be classified as IDBs and the interest on the obligations generally will not be exempt from Federal income tax. However, such obligations may qualify for tax-exempt status if the proceeds are deposited with a financial institution under a "loans to lenders" program and are then reloaned to customers of the financial institution for projects qualifying for tax-exempt financing. See Treas. Reg. § 1.103-8(a)(4).

Consequently, State and local government agencies that issue tax-exempt bonds can invest the proceeds of tax-exempt bond issues in certificates of deposit issued by Federally insured banks and thirft institutions if the banks and thrift institutions reloan the funds for qualifying purposes. These certificates of deposit then can be pledged as security for repayment of the tax-exempt bonds. Recently, it has been determined that these tax-exempt bond issues can be structured so that the certificates of deposit will be insured by either the Federal Deposit Insurance Corporation (FDIC) or the Federal Savings & Loan Insurance Corporation (FSLIC) in an amount up to $100,000 per holder of the tax-exempt bonds. The FDIC or FSLIC insurance of the pledged certificates of deposit effectively provides a Federal guarantee of these tax-exempt bond issues.

Section 2 of H.R. 1635 would add a new provision to the Internal Revenue Code to deny tax-exempt status to IDBs that are backed by Federal deposit insurance.

Under this new provision, interest on an IDB that otherwise would qualify for tax-exempt status will be subject to tax if a significant portion of the proceeds of the issue are to be invested in deposits in a financial institution whose deposits are eligible for FDIC, FSLIC or other Federal deposit insurance. The new provision that would be enacted by H.R. 1635 is similar to the provision proposed in S. 1601, a bill introduced by Senator Dole at the request of the Administration. However, the provision in S. 2061 would apply to all types of FDIC or FSLIC insured bonds that otherwise may be exempt from taxation under section 103(a) of the Code, not just IDBs. In addition, S. 1061 would apply only if a significant portion of the issuer's obligations were in fact insured (rather than merely deposited with a Federally insured financial institution).

For purposes of the new provision, the investment of proceeds of a bond issue will not be taken into account to the extent that such proceeds are invested: (1) for a temporary period until needed for the purpose for which the bonds were issued; (2) in investments relating to debt service; or (3) in a reasonably required reserve or replacement fund (as defined in Code section 103(c)(4)(B)).

The Administration has very strong reasons for supporting a prohibition on tax-exempt bonds insured by FDIC or FSLIC. Placing the credit of the United States behind an obligation that is exempt from Federal taxation creates a security that is superior in the market to the direct obligations issued by the Federal government. A Federally guaranteed tax-exempt obligation also has a distinct competitive advantage over all other tax-exempt obligations issued by State and local governments. As a result, Federal guarantees of tax-exempt obligations increase the borrowing costs of Federal, State and local governments.

Because of these and other considerations, there is an established Federal policy against Federal guarantees of tax-exempt obligations. The Public Debt Act of 1941 prohibits the Federal government from issuing tax-exempt obligations directly; and numerous other statutes preclude Federal guarantees of tax exempts in other contexts. The use of FDIC or FSLIC insurance to guarantee tax-exempt bond issues violates this established Federal policy.

The use of FDIC and FSLIC insurance to provide effective Federal guarantees of tax-exempt obligations is particularly alarming because of two factors. First, unlike other Federal loan guarantee programs, loans are guaranteed under the deposit insurance programs whenever an insured institution accepts a qualifying deposit, without requiring any affirmative step to be taken by a Federal agency to grant the guarantee. Second, the deposit insurance programs are essentially open-ended in that they are not subject to any dollar limitations on the amount of loans that may be guaranteed. Thus, if the combined use of the tax-exempt borrowing privilege and Federal deposit insurance is not prohibited, there will be virtually no limit on the ability to obtain effective Federal guarantees of all kinds of tax-exempt obligations.

Before proposing the legislation introduced in the Senate as S. 1061, the Treasury Department studied a number of other possible alternatives to deal with tax-exempt bonds backed by Federal deposit insurance. We concluded, however, that legislation to deny tax-exempt status to these obligations would be the most effective means to cut off the flood of new Federally guaranteed bond issues. The Administration bill pending in the Senate generally is effective for bonds issued after April 15, 1983. This proposed effective date was publicly announced in a Treasury news release on March 4. The April 15 effective date, which differs from the effective date of the provision in H.R. 1635 by only one day, was designed to allow bonds already "in the pipeline" to be issued without hardship. In retrospect, the April 15 effective date may well have been too generous. Althought we do not have precise figures concerning the volume of FDIC-and FSLIC-backed bonds issued between March 4 and April 15, one tax news service reported on March 29 that a single bond rating agency had pending requests to provide ratings on $4 billion of these obligations, involving about 400 separate issuers and 600 separate bond issues. This sort of report makes it clear both why legislation such as H.R. 1635 and S. 1061 is needed and why the April 15 effective date must be maintained.

The Committee should note that S. 1061, unlike section 2 of H.R. 1635, applies to all tax-exempt bonds, not just to IDBs. The policy reasons against Federally guranteed tax-exempt bonds apply with equal force to bonds that are not IDBs. We strongly urge this Committee to expand the coverage of section 2 of H.R. 1635 to all FSLIC or FDIC insured tax-exempt bonds.

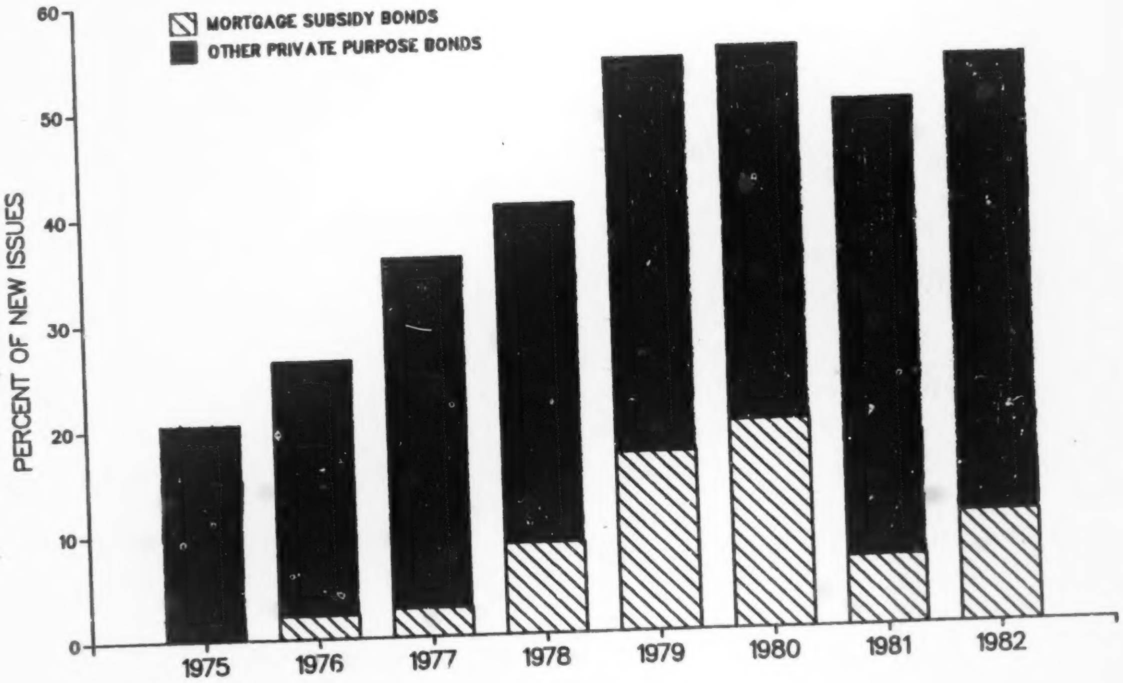
CONCLUSION

For the reasons discussed above, the Treasury Department strongly favors the enactment of additional restrictions on private purpose tax-exempt bonds. We regard further restrictions as essential if Congress decides, over the Administration's objection, to extend the MSB program. We support additional restrictions on tax-exempt IDBs of the type proposed in H.R. 1635. In addition, we would like to explore with this Committee the possibility of enacting State volume limitations or other comprehensive restrictions applicable to all types of private purpose tax-exempt bonds.

This concludes my prepared remarks. I would be happy to respond to your questions.

CHART 1

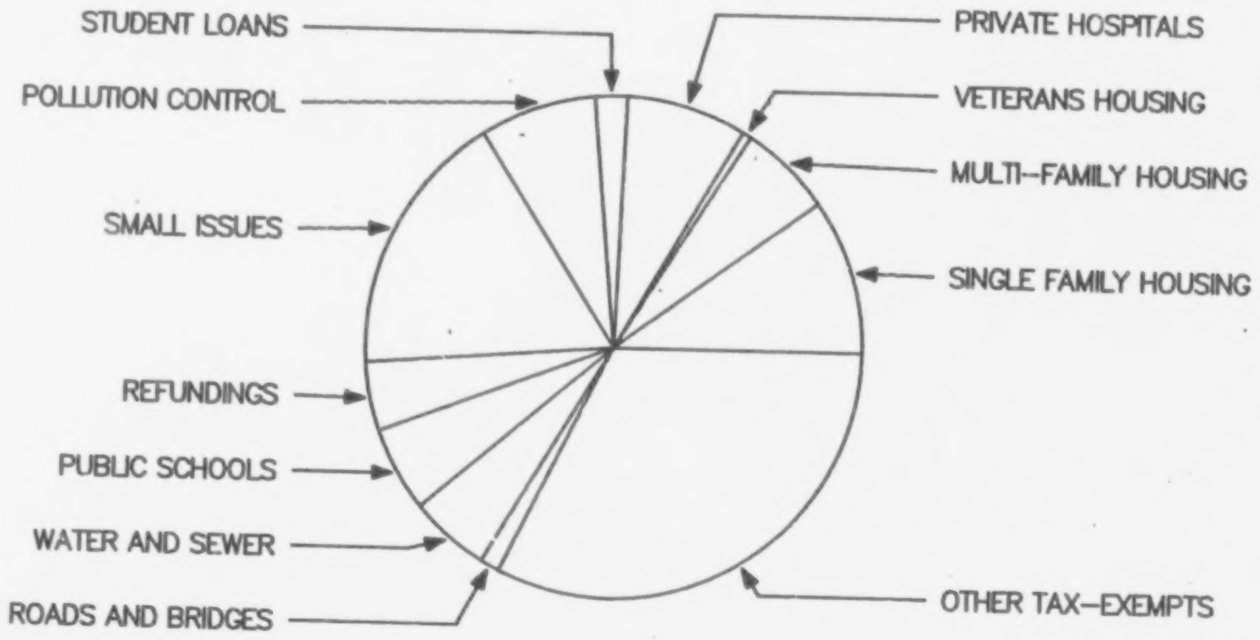
PROPORTION OF LONG-TERM TAX-EXEMPT BOND ISSUES FOR PRIVATE PURPOSES — 1975 TO 1982



OFFICE OF TAX ANALYSIS, DEPARTMENT OF THE TREASURY, JUNE 14,1983

CHART 2

TYPES OF LONG–TERM TAX–EXEMPT BONDS – 1982



OFFICE OF TAX ANALYSIS, DEPARTMENT OF THE TREASURY, JUNE 14,1983

Table 1
Volume of Long-Term Tax-Exempt Issues by Type of Issue - 1975 Through 1982
(In billions of dollars)

	Calendar Years							
	1975	1976	1977	1978	1979	1980	1981	1982
Total long-term tax-exempt issues 1/	31.3	35.0	46.8	49.0	48.1	54.9	56.7	85.8
Total private purpose tax exempts	6.2	8.3	13.3	16.1	25.0	29.3	27.6	44.0
Housing bonds	1.5	2.7	4.5	7.1	12.1	14.0	5.6	14.3
Single family MSB's	0.0	0.7	1.0	3.4	7.3	10.5	3.6	8.6
Multi-family IDB's	0.9	1.4	2.9	2.5	2.7	2.2	1.1	5.2
Veteran's GO bonds	0.6	0.6	0.6	1.2	1.6	1.3	0.9	0.5
Private non-profit hospital bonds	1.4	1.9	3.3	2.3	2.3	2.6	3.3	6.7
Student loan bonds	0.0	0.1	0.1	0.3	0.6	0.5	1.1	1.8
Pollution control IDB's	2.0	2.1	3.0	2.8	2.5	2.5	4.3	6.5
Small issue IDB's 2/	1.3	1.5	2.4	3.6	7.5	9.7	13.3	14.7
Refunding bonds	0.9	3.5	9.6	9.3	1.9	1.6	1.2	3.8
Other long-term tax exempts 3/	24.7	23.2	23.9	23.6	21.7	24.0	27.9	38.0

Office of the Secretary of the Treasury
Office of Tax Analysis

June 14, 1983

1/ Total publicly reported bonds from Bond Buyer, plus estimate of privately-placed small issue IDB's.

2/ Small issue IDB's issued by economic or industrial development authorities from Congressional Budget Office survey, plus additional small-issue IDB's for proprietary health facilities issued by other types of authorities.

3/ Includes State and local government financing for public facilities and some private purpose debt (other IDB's and non-profit educational facility bonds) that could not be identified or classified.

Chairman ROSTENKOWSKI. Thank you, Mr. Secretary. We appreciate your comments.

Dr. Sulvetta, you may proceed with your testimony.

STATEMENT OF ANTHONY J. SULVETTA, DEPUTY ASSISTANT SECRETARY-DESIGNATE FOR ECONOMIC AFFAIRS, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Mr. SULVETTA. Thank you. Mr. Chairman and members of the committee, I appreciate the opportunity to appear before the Ways and Means Committee to present the Department of Housing and Urban Development's views concerning the use of tax-exempt mortgage subsidy bonds [MSB's] to finance private homeownership.

I would like to begin by complimenting the committee on its foresight in calling the hearings. Many have expressed concern that the dream of homeownership is becoming less achievable. Indeed, such concerns have prompted legislative proposals to repeal the sunset date for the issuance of mortgage subsidy bonds.

My views on the issue are similar to yours, Mr. Chairman, in that I agree that those who seek to repeal the sunset date for mortgage subsidy bonds must address the findings of the recent General Accounting Office report on housing bonds.

In my testimony today, I try to provide information that will be helpful to the Congress in addressing this report. My information is of two sorts: The first is whether mortgage subsidy bonds provide a relatively efficient method of Federal assistance to first-time home buyers, particularly within the context of the housing recovery that is now under way. The second is the impact of that assistance on overall homeownership. Obviously, these are important questions since we need to scrutinize all Federal expenditures for effectiveness and efficiency.

Before moving to the specifics of the mortgage subsidy bonds and their effects, I would like to briefly discuss what I believe are very encouraging developments in the housing sector. This context is important because in evaluating the goals of mortgage subsidy bonds we need to be cognizant of the role that Federal expenditures can play in either helping or undermining the very strong housing recovery that is now underway.

Even a very short extension of the mortgage subsidy bond program can substantially increase the deficit. Rather than pursue what I believe is a self-defeating approach first, consider the events in the housing sector.

Total housing starts in the first third of this year are at a 1.65 million unit annual rate. This is more than 80 percent over the level of a year ago, and the highest level in 3½ years. Starts of single-family units—1.06 million units rate—are up 81 percent over the year earlier level. Total new housing permits are also up sharply with the first 4 months of 1983—1.5 million units—almost 80 percent higher than a year ago.

At this stage of the business cycle, five quarters from the housing trough of November 1981, this is the strongest housing recovery since World War II.

The 90-percent gain in total starts since the housing trough in the fourth quarter of 1981 is nearly double the increase in the comparable five quarter period of the best previous housing recovery in 1975–76.

The housing recovery is not the result of new spending programs. Rather, it is due to the significant reductions in inflation and increases in economic growth. In other words, it is due to the President's economic recovery program now taking hold.

By far the best news for housing is the very sharp drop in mortgage and inflation rates. However, in recent weeks that decline in rates has stopped. Unless Congress sends a clear signal that unjustified spending will not be enacted, the prospects for further improvements on interest rates will be diminished.

Thus, from an overall economic perspective the extension of the mortgage subsidy bond sunset could do more harm than good. What I would like to turn to now is the effects that mortgage subsidy bonds have on homeownership.

The General Accounting Office report contains useful data on who has been receiving mortgage subsidy bond financing. The question then becomes what can be said from these data about the impacts that mortgage subsidy bonds are having on the ability of American households to achieve homeownership?

There are two ways that a subsidy can affect homeownership. One is to permit households which never would have become homeowners to do so. Such households are primarily households which expect to have low or moderate incomes over their entire lives. In terms of the traditional husband and wife households, these households number about one in every eight. A subsidy might convince them that they can afford to become homeowners. But I suspect that it would have to be a very steep subsidy, much more than can be provided through mortgage subsidy bonds.

The second group of potential first-time home buyers is the great majority of households which start out renting or living with parents until they earn sufficient income and accumulate cash assets to buy a home. This normal life cycle process is not long. For 1980, over three-fourths of all husband-wife households were homeowners by the time they were 30 to 34 years of age.

If the issue is whether many households which would not otherwise become homeowners are permitted to do so by mortgage subsidy bonds, the answer can only be found in the type of data that the GAO collected.

As usual, the data can be read and its implications phrased in different ways. The General Accounting Office concluded that "most loans were not made to low- and moderate-income households." The Council of State Housing Agencies concluded from the same data that "mortgage subsidy bonds enabled moderate-income families to purchase moderately priced homes."

The difference is one of semantics and focus. The fact is that first-time home buyers have always tended to be moderate-income households buying moderately priced houses. Currently, those households are frequently not families, but single persons.

For example, we know that in 1980, 15 percent of all first-time home buyers were single-person households. GAO finds that 23 percent of the mortgage subsidy bond recipients in 1982 were also one-person households.

In addition, most first-time home buyers have not secured what are considered high incomes, mostly because they are so young. Neither are they low or moderate income by the definition used by GAO, that is, less than 80 percent of median income. Of all first-time home buyers in 1980, 31 percent had incomes less than 80 percent of the local median. The General Accounting Office found that only 23 percent of mortgage subsidy bond recipients had incomes less than 80 percent of their local median.

These numbers indicate that mortgage subsidy bonds are primarily serving the general population of first-time home buyers who have traditionally bought without the assistance of mortgage subsidy bonds. The heart of the matter is that about 84 percent of mortgage subsidy bond recipients were between 20 and 35 years old——

Chairman Rostenkowski. Dr. Sulvetta, I will ask you to suspend until Mr. Pickle returns.

The committee will stand in recess.

[Recess.]

Mr. Pickle [presiding]. The committee will resume its order of business. Dr. Sulvetta, you were testifying. I believe the chairman called a temporary cessation. If you will resume, sir, we will proceed.

Mr. Sulvetta. Thank you, Congressman Pickle.

These numbers indicate that mortgage subsidy bonds are primarily serving the general population of first-time home buyers, who have traditionally bought without the assistance of mortgage subsidy bonds. The heart of the matter is that about 84 percent of mortgage subsidy bond recipients were between 20 and 35 years old, 61 percent were single or two-person households, and two-thirds earned between $20,000 and $40,000.

For these households, a subsidy may change the timing of their decision. For example, instead of waiting for their incomes to increase, a subsidy will permit these households to become homeowners somewhat sooner. Only if the subsidy were much more targeted with respect to lower income households and also much greater would it strongly influence those households which would never become homeowners without a subsidy.

Even in this case, effective targeting would be difficult. There would be a large number of very young households which, because they are just starting, would have modest enough incomes to qualify.

Granting that mortgage subsidy bonds as currently targeted are not effective in increasing homeownership among the permanent renter group of households, are they needed in the 1980's to enable the traditional group of first-time home buyers to achieve the goal of homeownership? This is certainly a valid question, considering the roller-coaster ride of housing costs in the last 10 years.

To answer this question, we need to consider the problems which might be preventing these households from purchasing a home. Basically, there are three kinds of problems: down payments, high initial monthly payments relative to income, and the high net cost of homeownership. There is some validity to each of these concerns.

The first problem, down payments, has always been a concern and is one reason why FHA programs are so popular with first-time home buyers. In 1982, the average age of FHA-insured home buyers was similar to those of recent years and lower than those in any year prior to 1973. The perception of the downpayment problem is misleading because households usually can save the 3 to 5 percent down payment needed for an FHA-insured loan within a relatively short time.

The source of the more fundamental affordability problem, high monthly payments, is clearer. Expectations of further inflation have raised mortgage rates from 6 percent in the 1960's to 13 percent today. Monthly payments on a 30-year mortgage at 13 percent are twice as high as on a mortgage at 6 percent. These payments require such a large portion of household income that lenders become concerned about the potential difficulties in meeting the payments of any unusual expenses or if a drop in income occurs.

The urgency of the affordability problem became apparent when interest rates rose beyond 13 percent, since, at that point, most builders and sellers of existing homes had to offer financing at rates in the 12 to 13 percent range in order to make sales. The effort to keep payments low has generated many alternative mortgage forms, such as FHA-insured graduated payment mortgages [GPM's], which permit sharp reductions in initial mortgage payments. We believe that GPM's effectively address the problem of high initial monthly payments faced by first-time home buyers.

For example, one of FHA's graduated payment mortgages lowers initial monthly payments by 25 percent. In our current legislative proposal, FHA is requesting authority to insure a range of new instruments that will further help alleviate the affordability problem.

If interest rates continue to decline, so will the affordability problem. However, in recent years something dramatic has happened to the real net cost of housing. We estimate that the cost of homeownership has risen by 40 percent since 1978, after accounting for tax breaks and appreciation in house value.

This high cost is due to the high prices of houses and the continuing high cost of funds in a period of relatively low inflation and appreciation in home values. A sound overall economic program will solve the cost of funds problem, and the Department has taken steps to deal directly with the house price through the joint venture for housing affordability.

The joint venture demonstrates that important deregulation and cost savings can take place at the local level. By allowing fast-track processing, by zoning for higher density to reduce land and infrastructure costs, and by avoiding overly wide street and excessive lighting requirements, localities can make housing affordable. From the original 12 sites in the demonstration, the joint venture now has almost 30 sites participating.

In summary, it is not surprising that many younger households today feel that the burden of homeownership costs looms larger for them. For many, this seeming inequity justifies a subsidy to those who can buy anyway as well as those who cannot.

However, a slightly longer perspective suggests that housing costs are only slightly more burdensome today than they were in the early seventies, before the inflationary boom. The expected net cost of home ownership in the spring of 1983 is estimated to be comparable to that of 1970. While these costs are much higher than estimated costs in 1978, they are not only within the range of recent past experience, they are similar to those prevailing during the late 1960's and early 1970's when income growth was substantially higher.

In my view, if there is a barrier to achieving home ownership it has been the slow rate of income growth, a problem being successfully addressed by the President's economic recovery program. The recent resurgence in housing suggests that the program is now taking hold and young households are once more able to take the step into home ownership.

However, because of uncertainties concerning the level of Federal expenditures, this recovery is still a fragile one. The discussions of this committee on the complex issues before you today can have a distinct effect on the chances for that recovery moving into sustained growth. In this context, the Department continues to favor the sunset provisions.

I thank you.

Mr. PICKLE. We thank you, Mr. Secretary, and appreciate your testimony.

My comments will be directed to Secretary Chapoton. I appreciate your testimony very much in support of H.R. 1635, the bill that I and about 9 or 10 other members of this committee have sponsored.

I just cannot impress on you the need now to put your muscle behind your testimony and to help us pass meaningful legislation in any way that you can. We invite your active help.

As I view it, the only suggestion that you made primarily that would differ from the bill I have introduced is that you might be willing to entertain somewhere in the outline of this bill a State cap, either separately or in addition to or as a part of the overall approach. This would be a limitation.

Mr. CHAPOTON. That is correct, Mr. Pickle. The State cap would not necessarily have to be an alternative. It could be in conjunction with other types of limitations. The suggestion for a State cap does grow somewhat out of frustration with the inability to deal with the problem elsewhere through these other approaches.

Our point has been last year and continues to be that the decisions on which local projects deserve a subsidy should be made at the local level, but there has to be some means of making the decision at the local level have substance, have meaning, and today there is none.

Mr. PICKLE. Did your testimony suggest an amount for a State cap?

Mr. CHAPOTON. No, sir, we have not suggested an amount, and that would be obviously a major difficulty. The second difficulty would be devising a method for sharing the amount per State between the State government and the local government.

But I do not want to act like the amount would be easy, but it certainly would be doable. We are looking at that.

Mr. PICKLE. As I remember, when we were considering this IDB matter when TEFRA was before us, one of the recommendations that the administration had made at that time was that the issuer of the bonds ought to also contribute a certain amount, a fixed amount, as a part of the project to evidence their good faith that it is serving a public purpose.

Mr. CHAPOTON. That is correct.

Mr. PICKLE. In your testimony today you again suggest that that should be made a part of the measure.

Mr. CHAPOTON. Yes, sir.

Mr. PICKLE. I presume you are recommending that we also consider that possibility?

Mr. CHAPOTON. That is correct, yes, sir.

Mr. PICKLE. Do you have a figure in mind in what would be required?

Mr. CHAPOTON. Last year we suggested 1 percent of the cost of the project, I believe, 1 percent of the face amount of the bonds, and we spent a lot of time coming up with that figure. We have not reexamined it, but it seemed that that made sense.

We also said it could be provided by a grant to the project, by a provision of special services to the project, or by local tax-exemption.

Mr. PICKLE. You are saying that if a city or a county wants to issue these tax-exempt bonds, IDB bonds, they have got to put up at least 1 percent of the face value of that project?

Mr. CHAPOTON. That is correct.

Mr. PICKLE. Gross value, only 1 percent?

Mr. CHAPOTON. Yes, sir, our point is that the amount can be very, very small, but it is spending local funds, and once you require any expenditure of local funds on the project you are going to by necessity create local pressures to examine the merits of the project.

Mr. PICKLE. If I remember correctly, when that was proposed last year you could hear the squealing throughout the United States from every city and county. They did not want to do that. But if you ask only 1 percent, that is a very small request, it seems to me.

Mr. CHAPOTON. It seems so to us, too.

Mr. PICKLE. Well, I thank you for your testimony. I am not going to prolong it because you support the measure, and I elicited your active support in helping us that way because if we do not we are going to weaken the traditional tax-exempt bond program. It has already been weakened significantly, and if we do not do something to stop that you are going to kill it, and then the cities and the counties have no means, really, to finance their public purpose projects, and traditionally the Congress has always given the cities and the counties the right to use tax-exempt bonds for the purposes of financing those public purpose programs.

Mr. CHAPOTON. Yes.

Mr. PICKLE. As appealing as IDB's may be, we have a greater purpose in trying to curtail it because of the need to maintain the tax-exempt program.

Well, I thank you, Mr. Secretary.

Now the Chair would recognize Mr. Downey.

Mr. DOWNEY. Thank you, Mr. Chairman.

Thank you, Mr. Chapoton and Mr. Sulvetta for your testimony.

Buck, I want to ask you a question specifically about mortgage revenue bonds and how Treasury calculates the cost to the Government. Can you tell me what you think the mortgage revenue bond each year for the next couple of years will cost?

How much will it cost in 1983 and in 1984?

Mr. CHAPOTON. Mr. Downey, the new bonds issued, is that what you are talking about, the revenue cost if you extend the sunset?

Mr. DOWNEY. For those 2 years.

Mr. CHAPOTON. The revenue loss created by the new bonds issued would be $0.1 billion in 1984, $0.3 in 1985, $0.6 in 1986, $1 billion in 1987, and $1.4 billion in 1988. And, of course, the revenue loss continues as long as the bonds are outstanding.

Mr. DOWNEY. Right. Can you give me an example of where we calculate the cost of a program on a 20- or 30-year basis? Are there other programs where we consider the life of the bonds as to be the potential cost of a program, subsidy program?

Mr. CHAPOTON. That is a very important point. Other programs we can terminate or not terminate at will. The problem here is the bonds issued for 1984, if you have a 1-year extension of the sunset, are necessarily out there for as long as the holders have them, and so the loss is committed. You cannot reverse yourself.

Mr. DOWNEY. But in all fairness to this program, this is really the only place that we have ever figured out a cost based on the life of the bonds, is it not?

Mr. CHAPOTON. Well, Mr. Downey, I think we figure the cost of any current services—when we talk about current services, we figure the current law cost of programs over the period during which——

Mr. DOWNEY. For instance, if we were to take the 1981 Tax Act and figure out the cost to the Treasury for 30 years, it would be significantly larger, for instance, than a 3-year or a 5-year period, is that not correct?

Mr. CHAPOTON. That's correct.

Mr. DOWNEY. Let me ask you some other questions. Let me just try and figure out the way in which we figure the cost of the amount of money that tax-exempt bonds displace. My understanding is that we figure a dollar-for-dollar loss, is that correct, for every dollar of noninvested——

Mr. CHAPOTON. We use a 30-percent tax rate but it is difficult to determine what the exact rate should be, and people disagree on that. Some think it should be higher. Some think it should be lower. Although we believe 30 percent may be conservative, we think it is correct to use 30 percent.

We assume that more tax-exempt bonds in the system simply moves income out of taxable income into tax exempt.

Mr. DOWNEY. Do we assume that a dollar of tax-exempt bonds displaces on a dollar-for-dollar-basis taxable bond investment? Is that the way it's figured?

Mr. CHAPOTON. Mr. Downey, we are assuming a portfolio shift. The point is often made that people will shift from other tax-preferred income into tax-exempt bonds. We are assuming a sequence of portfolio shifts. In short, the answer to your question is yes.

Mr. DOWNEY. In all fairness, Buck, in trying to figure out the amount of money, is it not a portfolio shift not necessarily dollar for dollar; indeed, potentially, people are taking money out of their portfolio that is only partially taxed and placing it into something that is tax exempt.

So in fairness, when we calculate the cost, it is not a dollar of tax exempt or a dollar of tax. It is something much less, maybe 20 percent less or 30 percent less. Is that not——

Mr. CHAPOTON. The problem with that analysis, and that analysis is often made, it is true when you try to trace a particular dollar it may come out of a tax-deferred investment, but somewhere in the system money is coming out of a taxable investment to replace that dollar. I think the dollar-for-dollar analysis is sound.

Mr. DOWNEY. Mr. Sulvetta, let me ask you a question about your testimony because I think some of the premises dictate different conclusions, but I am not sure that I can see them all here.

You say on page 6 that:

> Granted that mortgage revenue bonds as currently targeted are not effective in increasing home ownership among the permanent renter groups in households, are they needed in the 1980s to enable the traditional group of first-time homebuyers to achieve the goal of home ownership?

In a way it seems to me the first half of your sentence answers your question, but let us keep an open mind. You say this is certainly a valid question considering the roller-coaster ride of housing cost in the last 10 years. Well, do we need it or do we not need it to provide opportunities for homeowners over the next 10 years considering the roller-coaster ride that we are on?

You talk about three criteria, but I am not sure that your testimony answers that question.

Mr. SULVETTA. In my opinion and I think that of the administration and the Department, we do not need mortgage revenue bonds, and they serve the same group of people—first-time homebuyers, particularly single-person households who could have purchased without assistance.

Mr. DOWNEY. That are served by other programs?

Mr. SULVETTA. That are served by the current FHA program and by those proposals that we have made in our legislation amending some of the instruments to be used. In addition, they are assisted by the joint venture on affordable housing.

Mr. DOWNEY. Mr. Chairman, I have other questions, but I will certainly wait for the next round.

Chairman ROSTENKOWSKI. Mr. Duncan will inquire.

Mr. DUNCAN. No questions, thank you.

Chairman ROSTENKOWSKI. Mr. Rangel will inquire.

Mr. RANGEL. Thank you, Mr. Chairman.

Secretary Sulvetta, I notice you are described as Deputy Assistant Secretary designate. What did you do before you were appointed?

Mr. SULVETTA. Prior to my current position, I was a consultant in Washington for 2 years, owning my own firm. Prior to that I was at the Office of Management and Budget as a senior economist, and prior to that I directed EDA's program evaluation division.

Mr. RANGEL. Have you ever been involved in any housing programs at all?

Mr. **Sulvetta**. Yes; while at OMB I worked for over 3 years in housing finance.

Mr. **Rangel**. Where?

Mr. **Sulvetta**. While at OMB as a senior economist I worked on housing finance issues, housing legislation, examined the quality of American housing, and housing demographics.

Mr. **Rangel**. I gather from your testimony, Mr. Secretary, that you think the best thing this Congress can do for homeownership is to allow the President's economic recovery to take place. Is that true?

Mr. **Sulvetta**. That is one of several things sir, because I believe the major crisis, if there is a crisis, is income growth and——

Mr. **Rangel**. If there is a housing crisis?

Mr. **Sulvetta**. If there were a perceived affordability issue in first-time homeownership, I believe the cause of that is income growth, and the President's program will tend to increase incomes.

Mr. **Rangel**. Now, can you tell me any program that HUD has, other than relying on the President's economic recovery package? In other words, your testimony sounded like OMB, it sounded like Treasury, but I gather that you believe the wrong people are being serviced by mortgage-subsidy bonds, that it should be targeted but you can't target it. So, the best thing to do is to wait until the President's program resolves the economic problems that the country is having.

I would like to know whether or not HUD has come up with any suggestions that could possibly make the mortgage-subsidy bonds more equitable and targetable to low-income families. Do you have any plans at all or recommendations to make?

Mr. **Sulvetta**. Well, sir, may I answer that in two parts?

Mr. **Rangel**. Sure.

Mr. **Sulvetta**. I do not believe we are waiting any longer. I believe the boom is here.

Mr. **Rangel**. What is that?

Mr. **Sulvetta**. I do not believe we are waiting any longer. I think the boom is here.

Mr. **Rangel**. The boom is here?

Mr. **Sulvetta**. Yes. It has started——

Mr. **Rangel**. Would you tell me what part of the country this boom is taking place in, because every time I ask the question, they say, of course, we do not mean your district, and we do not mean the city, and we do not mean the Northeastern area.

Is the boom anywhere near New York City at all?

Mr. **Sulvetta**. Very good. Sir, in a serious vein, nationally, as I had indicated in my testimony, housing starts were at 1.65 million units annualized for the first quarter of this year, which is a considerable start when one considers the depth to which we had sank earlier.

In reference to the second part of the question, yes, the Department has the joint venture on affordable housing program to reduce the cost of housing by using local communities to remove some of the regulatory impediments to housing cost that will help lower price of housing for low- to moderate-income families.

Mr. **Rangel**. Just deregulation and joint ventures with the private sector?

Mr. SULVETTA. And, sir, we are also asking for extended or more viable use of FHA through alternative mortgage instruments.

Mr. RANGEL. Would you consider taking a look at where this program has worked, and the economically depressed areas where it is obvious that existing HUD programs have not been of any assistance, to see whether or not with the proper safeguards, HUD could see its way clear to use these mortgage bonds to provide housing for low- and moderate-income citizens?

Would that be asking too much of HUD?

Mr. SULVETTA. Sir, I think HUD is doing that through its enterprise zone concept by trying to channel investment and productive capital resources that will employ people——

Mr. RANGEL. This concept has been going on for 2½ years, you know, and we have not been moving on this housing issue. I should wait for the concept to catch up with the recovery?

Let me just ask in closing, this enterprise zone concept which HUD is relying heavily on, which used to be an urban enterprise zone—is it an urban and rural project that the administration is supporting——

Mr. CONABLE. You could not get the votes on this committee, Charlie.

Mr. RANGEL. Do you want to take my time, Mr. Conable?

This rural-urban program, would the Treasury Department support IDB's, at least for the enterprise zone concept?

Mr. CHAPOTON. Yes, sir; we have supported continued use of IDB's in the enterprise zone area.

Mr. RANGEL. If we do not have those concepts into law, you would support it for targeted areas as long as it met those concepts?

Mr. CHAPOTON. If it met the enterprise zone concept, I assume you are correct. We would have to reexamine that, but if we did not have the enterprise zone in law—and we hope very much and think we will have it in the law—but that is the point, to have IDB financing in the targeted area.

Mr. RANGEL. Thank you.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Dr. Sulvetta, many of us are concerned about first-time home buyers. As a matter of fact, a delegation recently visited my office. Other than mortgage subsidy bonds, what housing programs are available to help first-time home buyers? Will there be any new programs? How does the efficiency of mortgage subsidy bonds compare with other programs?

Mr. SULVETTA. Answering the latter question first, we believe that mortgage subsidy programs are not very efficient, and all they do is accelerate slightly the timing of first-time homeownership.

Chairman ROSTENKOWSKI. Would you speak up?

Mr. SULVETTA. Answering the second part of the question first, I think that the mortgage subsidy bond program accelerates homeownership among those who would have bought in the first place.

As regards the Department and its initiatives, we feel that the market economy can do the job more effectively with respect to first-time homeownership, and that our legislative proposals are critical to achieving those goals.

Chairman ROSTENKOWSKI. Mr. Conable will inquire.

Mr. **Conable**. No questions, Mr. Chairman.

Chairman **Rostenkowski**. Mr. Flippo will inquire.

Mr. **Flippo**. No questions, Mr. Chairman.

Chairman **Rostenkowski**. Mr. Dorgan will inquire.

Mr. **Dorgan**. Just one question, Mr. Chairman.

First of all, Secretary Chapoton, I happen to agree that there is some need for targeting here and that certainly the private purpose tax-exempt issues have exploded in recent years, and there is a need to take a look at this whole area; and so I agree with you on that point.

I think the reason that it's exploded is because we have had a radical monetary policy, which if you take a look at a graph of interest rates throughout our history and come to the late part of 1979, then follow the graph from then to now, you will discover the effects on interest rates of a radical monetary policy. If that kind of monetary policy persists in the future, and given the story in the paper this morning, there is some feeling at least that we may not have decided to abandon the roller coaster vehicle at least, then I think you will always continue to have pressures for growth in these kinds of private purpose tax-exempt issues.

Mr. **Chapoton**. Mr. Dorgan, I might mention that the real growth, though, did take off in 1975–76. I think once people realize that there is in effect a free lunch here, there is no reason to limit it from their standpoint.

Mr. **Dorgan**. Yes. I understand that it has happened in the late 1970's but more dramatically in the last 3 or 4, 3 years particularly, when you could not find any way for a young couple to afford a home for the first time. They have had to search for alternatives.

Mr. **Chapoton**. If you are talking about mortgage subsidy bonds, that is correct.

Mr. **Dorgan**. Or aggie bonds where you could not find money available for beginning farmers as other farmers retired, and we wanted to get new people in, where money was not available because interest rates had moved the capital beyond their reach. You know, they moved to aggie bonds.

But that is specifically what I wanted to talk about. You did not mention the bonds that have been used in some of our rural States, so-called aggie bonds, in your testimony. Do you have any feelings about them and any recommendation with respect to aggie bonds?

Mr. **Chapoton**. The bill before you would prevent the use of tax-exempt financing for land, small issue tax-exempt bonds for land. We support that. That would obviously, I believe, totally stop that program.

One of the concerns expressed with respect to bonds for property is it makes financing cheaper for property and simply is reflected in the higher value of the property; so it increases the value of the existing property to the existing owner of land. Obviously it does not create any new land, and I think we question the wisdom of it.

Mr. **Dorgan**. Do you understand the need, if properly targeted, to provide some capital through the ag bonds that some States are using for beginning farmers?

Mr. **Chapoton**. We are not proposing the bill—the bill would not propose and we did not propose last year a total termination of the industrial development bond program by any means. If through a

State cap or otherwise you preserve the right for the State to decide that that is an activity it wished to support, then I think we would have no difficulty with it.

Mr. **Dorgan**. I thank you for your testimony.

[Mr. Dorgan submitted the following statement:]

Statement of Hon. Byron L. Dorgan, a Representative in Congress From the State of North Dakota

Mr. Chairman. Thank you for this opportunity to say a few words about industrial development bonds and agri-bonds and their impact on states like my home state of North Dakota.

Industrial development bonds have been abused in the past and I believe that this Committee is justified in holding these hearings and making some changes in the laws that govern these bonds.

However, it is important that this Committee preserve the ability of the states to issue agri-bonds, mortgage subsidy bonds and industrial development bonds in a responsible manner.

North Dakota and other states have successfully used agri-bonds to provide much needed credit for family farmers.

I support some tightening of regulations that would target loans from agri-bonds to family-size farms and beginning farmers, but it is important that the states not lose the ability to use agri-bond financing when they deem it important. Thank you, Mr. Chairman, for letting me express my views on this important issue.

Chairman **Rostenkowski**. Mr. Moore will inquire.

Mr. **Moore**. Thank you, Mr. Chairman.

Mr. Secretary, I was not here when you testified, but I finished reading your testimony. In particular I have a question in the area of the mortgage subsidy bonds for housing.

You did not cover in your testimony what you thought about a triggering mechanism in case there is an extension of the sunset. We talked about a trigger in the beginning when the program was passed, but this approach was not adopted. Say long-term mortgage rates exceed 14 percent, then this triggers in, and you are able to get the program going again. In other words, to have this on the shelf when interest rates get so high, it is the only way people can buy homes and homebuilders can stay in business. The program would not operate, however, at a time when interest rates are near or at normal long-term rates, and the money can be found in the conventional lending sector.

What do you think of such an approach, assuming the sunset is postponed?

Mr. **Chapoton**. Mr. Moore, you are right. I do remember that triggering approach was discussed in 1980. We have not, frankly, discussed it again at Treasury, but I can see some merits to that approach, because we would hope interest rates would not get to that point and at least that it would tend to limit the problem to the very severe situation. Even then, of course, it should be, as we point out in the testimony, if you have any extension of it, it has got to be targeted more carefully; but that would be another limitation on it that would make some sense.

Mr. **Moore**. I would like to ask both you and Dr. Sulvetta, if you would, to take a look at this and get back to me and submit it for the record, if the chairman will allow that to be done. If we followed that approach, what interest rate would you suggest for the trigger? When interest rates got beyond this point for a certain period of time, then this program would trigger in.

[The following was subsequently received:]

I. THE USE OF TRIGGERS TO INITIATE SUBSIDY PROGRAMS

Although a myriad of economic indicators could be used to "trigger" subsidy programs such as Mortgage Subsidy Bonds, their reliability as stabilizing mechanisms is problematic. There are two fundamental problems: first, the lack of simple, reliable relationships between housing activity and economic indicators and, second, the changing nature of cyclical activity. For example, casual observation tends to indicate that interest rates are a roughly coincident indicator of housing starts. When viewed over a relatively long time period, high interest rates tend to be associated with low levels of housing starts and vice versa. But for interest rates to serve as a useful trigger for housing subsidies, it is important that changes in interest rates accurately indicate significant cyclical changes in housing construction activity.

Short-term interest rates are not highly correlated with housing starts, using either quarterly or monthly data. For example, changes in the inflation-adjusted Treasury Bill rate—a measure of the riskless cost of funds—only weakly correlate with housing starts over the period 1959-1983. Approximately one time in every three would an increase in this rate portend a decrease in housing starts. Changes in the mortgage rate have a somewhat stronger relationship. However, they would still be misleading indicators the majority of the time.

Another problem with use of national indicators as triggers for counter-cyclical programs has to do with the changing composition of cyclical downturns in economic activity. In particular, economic fluctuations in regions, states, and local areas neither conform to national cycles nor behave consistently from cycle to cycle. As a result, even if it were possible to select a trigger that reliably coincided with a national cyclical downturn, the stimulus would not necessarily be targeted to the specific areas in need.

There are no simple mechanisms at hand to turn programs on and off. No single or composite piece of information consistently leads, lags, or coincides with turning points in the housing market. As a consequence, any trigger mechanism used will lead to false and unnecessary program activation.

II. RECENT TRENDS IN GNMA MORTGAGE-BACKED SECURITY GUARANTY OPERATIONS

The Government National Mortgage Association's (GNMA) Mortgage-Backed Security (MBS) program guarantees the timely payment of principal and interest on mortgage loans that have been packaged in a pool of mortgages. Securities representing shares in the particular pool are then sold. A number of studies have shown that this program has increased the flow of mortgage credit to creditpoor areas, thereby, increasing the supply of mortgage credit in these areas. The program has also induced non-traditional investors such as life insurance companies to invest more heavily in mortgages, thereby, increasing the supply of mortgage credit generally. The Government National Mortgage Association has almost exclusively served the moderate-income segment of the housing market.

So far, through the first 8 months of fiscal year 1983, GNMA has guaranteed $26.2 billion in MBSs. In in the last 3 months, GNMA has guaranteed $14.7 billion suggesting that its volume will likely exceed $45 billion in fiscal year 1983. Government National Mortgage Association officials are currently forecasting a volume of $48 billion for fiscal year 1983 under its fiscal year 1983 credit commitment limitation of $68.25 billion.

Mr. MOORE. What I am finding in my hometown is the fact that homebuilders and realtors want this extended mechanically. But then they tell me privately that every time we announce one of these bond issues back home, the entire market is dead. It just stops dead in its tracks. Everybody is waiting to see if they can get in line and get one of the special mortgage bonds. And if they cannot, then they may go back into the market conventionally. If they cannot, of course, they go on and do so. But it is causing an interruption in the market at a time when now they see no need for this. They would like to see it preserved and kept on the shelf when times get tough again, but they are finding it really interfering with the commerce now.

Of course, the people in the little bureaucracies we set up all over the country who run these bonds obviously want to see them continue, and we understand that. But I would appreciate your giving us that information. I, for one, would like to pursue this target interest rate approach.

Second, Mr. Secretary, from the point of view of good tax policy—and I have about concluded after my ninth year in the Congress and I guess fifth or sixth year on this committee, that there really is not any constituency in America for good tax policy, just like there is no constituency for good government. There's an attitude of "what helps me is what I want." That is all anybody seems to care about day after day as they come before our committee.

But just to be esoteric for a moment and talk about good tax policy, as you did in the beginning of your statement, is it not true that the growth of these private purpose bonds is eroding our tax base; it is cutting back on money that would otherwise be going to the Treasury, so the lost revenue then increases the deficit. That deficit increase in turn is reflected in pressure on this committee and the Treasury to find ways to recoup those lost revenues, such as discussing doing away with indexing that is supposed to go into effect on January 1, 1985.

Mr. CHAPOTON. Absolutely. It does narrow the tax base. We see the tremendous explosion in a sector of interest that is completely outside the tax base. We do not see any diminishing need for Federal revenues, so you end up with higher taxes imposed upon the base that is remaining.

It also, in a slightly different vein, as I pointed out in the testimony, is a back door increase in expenditures. We see this type of tax benefit sought with more effort when direct expenditures or loan guarantees are cut through the front door; that is, the Federal policy is not to expend further sums in this area. And then through tax-exempt financing or through direct Federal guarantees in some cases, the public tries to obtain benefits from the Federal Government just the same but that did not go through the budget process.

Mr. MOORE. It seems to me these folks who will come before us today testifying in favor of these programs and even extending them, are going to tell us we do not want you to raise taxes; we do not want you to create deficits; but that is precisely what they are asking us to do unless we increase the taxes on the average taxpayer across the country.

Mr. CHAPOTON. That is correct.

Mr. MOORE. Thank you very much, Mr. Secretary.

Chairman ROSTENKOWSKI. Mr. Shannon will inquire.

Mr. SHANNON. No questions, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Frenzel will inquire.

Mr. FRENZEL. Thank you very much, Mr. Chairman. Thank you, gentlemen, for your testimony.

I have a little different analysis than my distinguished colleague from North Dakota. I believe that our problems—that is, the high interest rates and others—are caused by a radical fiscal policy. That policy has developed outrageous deficits, and the monetary policy which followed has been a reasonable response to that uncontrollable, uncontrolled fiscal policy.

But be that as it may, I am pleased with the questioning of my colleague and temporary leader, Mr. Downey, with respect to mortgage revenue bonds. I hope we pass the bill soon so we can depose him from that position of leadership.

And I would like to talk about IDB's in general. I have been working with the Joint Committee to develop perhaps an amendment to the gentleman from Texas' bill. The amendment would either prevent or restrict a practice that is described as condo bonds or condo bonding in which the $10 million limit on small issues is avoided by selling off floors or wings or whatever.

And may I ask what Treasury thinks of such a possible amendment?

Mr. CHAPOTON. We would look with favor upon such a possible amendment. That has been a concern. We discussed that last year. We did not make a proposal with respect to it, but—and I am not really sure of the depth of the problem, Mr. Frenzel, but I know that it is going on, and it is a matter for concern.

Mr. FRENZEL. Thank you very much.

As soon as we have a proposal ready, we will serve it up to you.

I am also concerned about a question of mixed use regulations. That is, the IRS regulations require, in order for a residential rental project to qualify for a multifamily IDB, the project must occupy all of the building or structure, not just a portion thereof.

There was a particular problem within my State; other means to satisfy the needs of that particular development had to be used. But in the meantime, the regulations have prevented the development that included a structure, shopping arcade, kind of an integration of the project with residential rental housing.

And I cannot find anything in the legislative history of the statute to indicate that you could not have a mixed use situation, and yet your regulations, IRS regulations, require that. And it seems to me there is a good public purpose in encouraging diverse rental housing projects, so that we do not build another series of Pruitt-Igoes, just concrete boxes in which there are some residences and nothing else.

I am thinking of an amendment to modify this regulation unless the Treasury has given it some thought and might be willing to review that regulation. Could you comment?

Mr. CHAPOTON. Mr. Frenzel, I have not looked at that problem, and so I really could not comment. I know the regulations do impose the requirement that you state. I would simply have to rethink why that requirement was in there. I have not revisited that.

Mr. FRENZEL. I hope you will put that on your list of things to do. I have struck out with the IRS. The current practical problem has gone away. I think, for the future, your regulations should not discourage developments that will be attractive and will in turn stimulate responsible development within the area.

Mr. CHAPOTON. Then you would not undermine the 20 percent low- and moderate-income resident——

Mr. FRENZEL. No, the only change that I propose is to allow those to be used within mixed use application.

Chairman ROSTENKOWSKI. Mr. Pease will inquire.

Mr. PEASE. Thank you, Mr. Chairman.

I would like to thank our two witnesses this morning. Could I ask Mr. Chapoton to comment on the effect of ending these housing subsidy bonds on a State like Ohio, which really just got into the act within the last 4 or 5 months? They issued $300 million worth of these bonds, and made them available to the buying public. They were snapped up in a matter of 1 day. People were standing in line for 2 days at banks to try to get an opportunity to take advantage of it. And the builders that I talked with basically said that this came in at 10 percent, which would otherwise be 12 or 13.5 percent for these people, and they simply could not afford it.

What is the answer for a State like Ohio, if this program is ended?

Mr. CHAPOTON. Well, of course, Mr. Pease, they will snap them up. It is a Federal subsidy. I think the Department of Housing and Urban Development would be better able to discuss the possible impact. The result would be, though, that those homeowners would have a slightly higher mortgage rate. There is no doubt about it. Because the subsidy would stop.

The question that is often discussed is, what level of income—well, two questions. What level of income is being supported? That is, is the subsidy going to the income level that we would give a subsidy to if we did it more directly? And second, the efficiency of the subsidy. A third question is whether any subsidy is needed whatsoever, but I think that is the question that was addressed in the HUD testimony.

Mr. PEASE. Mr. Chapoton, you say in your testimony that you believe subsidies that provide homeowners with lower rates are unnecessary in view of other Federal assistance for low- and moderate-income home buyers. Perhaps you and Mr. Sulvetta can together enlighten me on what the other assistance is for low- and moderate-income home buyers and what the trends are in that other system.

Mr. CHAPOTON. The principal assistance, of course, is FHA financing. There are other HUD programs that Dr. Sulvetta can refer to.

Mr. PEASE. Is there anything besides FHA, Mr. Sulvetta?

Mr. SULVETTA. There is the Government National Mortgage Association's continually active participation in the secondary market to channel more funds toward the moderate- to low-income family households, which is another aspect of making sure the funds are available at a cost that is reasonable to first-time home buyers.

Mr. PEASE. What is the trend line for those two programs? Are they increasing or decreasing?

Mr. SULVETTA. I would have to get that information for you.

Mr. PEASE. You do not know offhand?

Mr. SULVETTA. Not offhand; no.

[The following information was subsequently received:]

GNMA MBS issue annual volume

[Calendar years in millions of dollars]

1973	$2,952.5
1974	4,552.7
1975	7,447.3
1976	13,764.2
1977	17,439.8

1978	15,358.3
1979	24,939.8
1980	20,648.6
1981	14,255.4
1982	16,011.3
1983 (5 mo)	20,899.5

Source: GNMA Office of the Controller.

Mr. PEASE. Could I ask whether the large revenue losses which you mention in your testimony, Secretary Chapoton, are included in the OMB projections of deficits over the next couple of years?

Mr. CHAPOTON. The revenue loss for mortgage-subsidy bonds are not, because under current law they sunset at the end of this year, and that is a current services budget.

Mr. PEASE. So if the sunset is removed, we would be adding to the deficit to the tune of billions of dollars?

Mr. CHAPOTON. We estimate $3.4 billion over the next 5 years, and of course for a period of time while the bonds are outstanding.

Mr. PEASE. I always like to get my signals straight——

Chairman ROSTENKOWSKI. Will the gentleman yield?

Mr. PEASE. Yes.

Chairman ROSTENKOWSKI. Mr. Secretary, are you saying, that you estimate a natural upward trend?

Mr. CHAPOTON. We are estimating two things, a significant upward trend nationally in the use of mortgage-revenue bonds, and then the effect, the upward effect on the deficit as a result of that.

Mr. DOWNEY. Would the gentleman yield?

Mr. PEASE. Certainly. I would be happy to yield.

Mr. DOWNEY. Mr. Chapoton, is it not correct that you projected the cost of a mortgage-revenue bond bill could be $100 million in 1984 and $300 million in 1985?

Mr. CHAPOTON. That is correct, $600 million in 1986.

Mr. DOWNEY. Sometimes we tend to confuse these estimate costs over a 5-year period with 1-year estimates, so $100 million next year is what we are talking about. I thank the gentleman for yielding.

Mr. CHAPOTON. If I might, I would simply point out again, though, once the bonds are issued in that year, they are out for 15, 18, 20 years, and the loss is going to occur over that period of years.

Mr. PEASE. One last thing. I would just like to get my signals straight from the administration. You would consider then that maintaining the sunset would be the fiscally conservative vote for the members of the committee who wished guidance on that?

Mr. CHAPOTON. We would think it would be the proper action for the committee to take; yes, sir.

Mr. PEASE. Thank you.

Chairman ROSTENKOWSKI. Mr. Hance will inquire.

Mr. HANCE. Thank you, Mr. Chairman.

You know, I have a lot of my chamber of commerce groups that support these programs. A lot of times they will even pass a resolution in support of IDB's, and those resolutions will often go on to have a last clause asking Congress to balance the budget and cut out welfare. They want to cut food stamps and other subsidies, which is fine, but IDB financing and mortgage revenue bonds are also subsidies, just like welfare programs are subsidies. This inconsistency always amazes me. Have you all looked at the possibility of limiting the tax exemption of private-issue IDB's to 50 percent of the interest paid on these bonds?

Mr. CHAPOTON. You mean if the holder could exempt only 50 percent?

Mr. HANCE. Of interest earned.

Mr. CHAPOTON. That would simply raise the interest cost on tax-exempt bonds. We have not looked at that. The spread now is around 20 percent. That is the difference. Tax-exempt, long-term rates are about 80 percent of taxable rates. You would raise the cost on tax-exempt bonds to about—I assume about 90 percent. So you would simply cause the interest costs of these obligations to go up. I assume you would be talking about on industrial development bonds only, and there is now no such distinction, and has never been in the law between the treatment of interest on industrial development bonds and the treatment of interest on normal public-purpose bonds.

Mr. HANCE. On mortgage revenue bonds, have you looked at the possibility of some type of trigger point tied to the economy, unemployment, interest rates, or some other factor?

Mr. CHAPOTON. Mr. Moore suggested that a moment earlier, and we agreed that we would look at that. He particularly talked about tying it to interest rates. I think that was discussed in 1980, when this legislation was first considered, and we will take a look at that.

Mr. HANCE. I think there is no doubt that some of these programs have had a beneficial effect at certain times, but I do know that some people are going to get hooked on that type of financing and continue to use it as times pick up and things get better.

I would like to see your reply to Mr. Moore.

Mr. CHAPOTON. Yes, sir.

Mr. HANCE. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Campbell will inquire.

Mr. CAMPBELL. Thank you, Mr. Chairman.

I want to tag onto what Mr. Moore said just a little bit. I think that we should explore a trigger. I think that is a reasonable way to go. I also want to look at part of your changes in the issuance or eligibility and the average sales price. That has served as a distortion in different ways for the issuance of mortgage revenue bonds. I think that the median price applied by FHA and others might be a better way to look at it, as you suggested in your testimony.

I will give you a prime example. In one of my areas, Greenville, S.C., they sold off a huge old mill village, and all of the houses were sold at $10,000 or $12,000. It completely distorted the market and knocked us out of eligibility for the issuance of bonds for that particular area until we could get some special legislation and a waiver from HUD. So there can be some distortions. We lost almost 1 year in the process of trying to get that worked out.

So, I am trying to point out that the median price will work against you sometimes, and I think that there is a better way to determine a median price for the eligibility. Let me ask you this, though. I look at the figures and, of course, I have to look at the national figures. Tell me what the various States have in State law governing this. I was in the State legislature in 1971. We set up the housing authority of the State of South Carolina, and at that time we set up the income limitations in an effort to get some targeting.

Right now, in the last 3 years, our average eligible family for a bond has been somewhere, over the 3 years, between $17,000 to $18,000. That qualified them for houses that averaged in the thirties. Using the other figures, I see that many are different, and obviously your national average cost of housing is up.

Tell me, if you will, what State laws do generally to govern this practice for State housing authorities.

Mr. CHAPOTON. Mr. Campbell, State laws do impose some income limits and some price limits. Of course, they vary from State to State. I do not have readily that information. I believe the Congressional Budget Office study does go into that. Most of the time, I understand the limits are relatively high, and I think you should understand that unless the State thinks it will reach its cap, then it has no motiviation to put a lower limit.

Now, most of the States probably will reach the cap this year, and therefore they have an incentive locally to target it to the areas they see need, but I do not have any specific information on what type of limits the States put on the programs.

Mr. CAMPBELL. You are proposing some changes in the nontargeted area so that it can be limited to first-time home buyers. Is that correct?

Mr. CHAPOTON. That is correct. It was that before TEFRA.

Mr. CAMPBELL. What percentage of the people we financed bought homes using mortgage revenue bonds were first-time home buyers last year? Well, I do not really think 1982 is a very good year to use. Let us use the year before. Do you have it?

Mr. CHAPOTON. We do not have that data and we do not know. We do not have a reporting requirement on these obligations, so there is no information coming to the U.S. Government that gives you that or other type of information that we would like to have.

Mr. DOWNEY. Would the gentleman yield?

Mr. CAMPBELL. Yes.

Mr. DOWNEY. On that point, prior to TEFRA, they would all have had to be first-time home buyers.

Mr. CHAPOTON. They would all, except in the targeted areas.

Mr. CAMPBELL. Except in targeted areas. Targeted areas were not included. It was only in nontargeted.

Mr. CHAPOTON. That is correct. In the targeted areas, as I point out in the testimony, in some States, because of the subjective criteria, it could be very large, in some cases over half the population of a State.

Mr. CAMPBELL. In my State of South Carolina, through May of 1983, we had a mixture of about 65 percent sale of existing houses and 35 percent of new construction for this year. Would that be somewhere on the mixture that you are getting across the country?

Mr. CHAPOTON. Mr. Campbell, I simply do not know.

Mr. CAMPBELL. I think it would be very helpful if we knew what we were financing. I would like to know. I asked my State for some of this information to find out where we were, and if we have a national policy on it. We have varying State laws, and I am not really interested in getting into the States. It would seem that we ought to be at least seeking some median level and some regional application to prices and income eligibility if we are going to get control over it. I am sure not going to vote to kill it, because I am for it.

Mr. CHAPOTON. That would argue very strongly for a reporting requirement which does apply as a result of TEFRA to other private purpose bonds. It does not apply to mortgage revenue bonds, and therefore that information will be difficult to obtain.

Mr. CAMPBELL. My time is up.

Mr. FRENZEL. Would the gentleman yield?

Mr. CAMPBELL. I do not have the time.

Mr. FRENZEL. I would like to know where you find those two-thirds new homes for $30,000.

Mr. CAMPBELL. Well, it is not two-thirds of new homes. Sixty-five percent were existing. Thirty-five percent were new. So we are back down to about one-third on the new.

Mr. FRENZEL. I would like to find an existing $30,000——

Mr. CAMPBELL. They were able to do that in what they built. The average price for the 3 years was about $35,000. There were quite a few innovative things that HUD allowed, as a matter of fact.

Mr. FRENZEL. Like no doors?

Mr. CAMPBELL. Like unfinished upstairs, with all your plumbing in. The family could buy and finish the upstairs. A few odds and ends like that were allowed in an innovative way to provide housing that could be expanded as the family grew.

Mr. FRENZEL. Thank you.

Chairman ROSTENKOWSKI. Mr. Jacobs will inquire.

Mr. JACOBS. Mr. Chapoton, when this legislation was passed, if I remember correctly, the cost of it to the Federal Government was estimated at about $2 billion. Am I right about that?

Mr. CHAPOTON. Mr. Jacobs, I do not have that number. I will pull that out.

Mr. JACOBS. I just wondered. I can understand if you do not have the figures with you. But if you submit a response, I wonder if you could submit, A, the estimate, and B, the reality, to see how close they come to one another.

Mr. CHAPOTON. We will do that.

Mr. JACOBS. Do you have any idea what the overhead is on this program, by which I mean the economic benefit which finally arrives in the bank account, or in the account of the first-time home buyer as distinguished from the amount that the bond actually cost the U.S. Government and State and local governments in consequece of whatever pressure it has on their interest rates?

Mr. CHAPOTON. That is a two-part question, both of which are very important points. We estimate that about two-thirds of the benefit of the Federal revenue loss flows through to the home buyer, inefficient to the tune of one-third, and I think the Congressional Budget Office found a great deal more inefficiency than that.

We also estimated generally that another $1 billion of tax-exempt bonds on the market raises the cost of other tax-exempt bonds by about 1 basis point, 0.01 percent. So you can factor in the cost.

Mr. JACOBS. The Carter administration people testified that it was just the other way around, that two-thirds of the loss to the

Treasury was in overhead, and about one-third finally blew through to the first time——

Mr. CHAPOTON. We may be talking about different things. One thing, you have the cost of administering this program.

Mr. JACOBS. I am not talking about that. I am talking about the cost to the Treasury altogether. In other words, the bondholder picks up a little bit. The bond salesman picks up a little bit—an awful lot. So I am just trying to figure out what the overhead is—if it is two-thirds, only a third, only a half. I do not know. Whatever the overhead is, I am trying to find out, how does that compare with the typical housing program administered by the fellow next to you there.

Mr. CHAPOTON. Well, I think we are now talking about an inefficiency in the financing alone. That is, we have a tax benefit. We have a tax exemption that has to be compared with the benefit flowing through to the mortgagee. That is one question. I think a second question is the administrative costs of subsidy that you are getting at, versus administering another program. I would have to let HUD answer that. But I am advised that our one-third figure is conservative, and that others do estimate that it is higher.

Mr. JACOBS. We would expect a conservative figure from this administration, but I would like to have—I do not want to take the time now, but if you people could just give it to us for the record, what is the overhead for this housing program, and how does it compare with the overhead for other housing programs, and do not other housing programs have more restriction on income? Are they not really for low-income people rather than folks to hit the jackpot in the lottery on this particular thing, the real jackpot, the governmental machinery being used by the bond sales people and the bond lawyers and so forth really to hit the jackpot.

The final question is, and Tom Downey and I went around and around on this when we first started this thing out, the other question is, if you are going to do this at all, why not just give a tax credit to the first time home buyer and let him have all of it? Why share the money with all these folks along the line?

Mr. CHAPOTON. That is a possibility we suggest in our testimony. I am not saying we would support it, because of the reasons I have already stated, but it would be more efficient than the mortgage subsidy bond program.

Mr. JACOBS. Peace.

Chairman ROSTENKOWSKI. Mr. Secretary, if current law remains in effect without changes, what are your estimates regarding the future growth in the volume of IDB's?

Mr. CHAPOTON. The volume of mortgage subsidy bonds we are estimating at $8.7 billion this year, $10.3 billion in 1984, $13 billion in 1985, $16.9 billion in 1986, $20.5 billion in 1987, and $23.6 billion in 1988, a tremendous increase in the volume of mortgage subsidy bonds, because we think, as I stated in my testimony, that the cap based upon 9 percent of the 3 previous years average of mortgage originations will go up dramatically.

Chairman ROSTENKOWSKI. Mr. Secretary, my question was directed toward IDB's.

Mr. CHAPOTON. Oh, I am sorry. IDB's? Well, we have them categorized in small issue IDB's. We estimate $16.3 billion now, $19.4

billion in 1984, $23.3 billion in 1985, and $34.7 billion in 1986. That is the largest single category. We would think, in dropping to the bottom line, and including extension of mortgage subsidy bonds, IDB's, total private purpose bonds would be about $48 billion in fiscal 1983, rising in 1985 to $67.6 billion, in 1986 to $88.1 billion, and then we assume the sunset of small issue bonds, so there would be a dropoff in 1987 to $63 billion, and up to $73 billion in 1988.

Chairman ROSTENKOWSKI. Will there be an effect on traditional municipal bonds such as those for streets and schools?

Mr. CHAPOTON. Yes, sir. There will be a tremendous effect of this volume. As I pointed out, most would agree that each billion dollar of bonds would increase the cost of public purpose bonds at least one basis point.

Mr. PICKLE. Would the Chairman yield?

Chairman ROSTENKOWSKI. Yes.

Mr. PICKLE. In that connection, though, you are talking about volume of the IDB's. I would like to point out to the committee that in the committee print made available to the committee, on page 19, on table 8, it lists the estimated revenue loss of these private purpose IDB's, and shows that in 1980, the estimated revenue loss for 1984 would be $10.1 billion; 1985, $11.5 billion; 1986, $13 billion; 1987, $14.3 billion; and 1988, $15.1 billion.

In other words, in the next 5 years, your revenue loss would be, conservatively estimating, somewhere in the neighborhood of $63 to $65 billion. Now, the bill we proposed is only really a moderate cutback on that. This shows the very large amount of revenue loss that we are going to face, and I think the committee ought to be mindful of that. I just wanted to point it out.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Matsui will inquire.

Mr. MATSUI. Thank you, Mr. Chairman.

I direct this question to Mr. Chapoton or the Deputy Secretary, one of the two. In view of the fact that the mortgage revenue bond program is about a $3 billion a year loss to the Treasury right now——

Mr. CHAPOTON. It is a little less than $2 billion this year, and it will rise to $2.8 billion in 1984.

Mr. MATSUI. And in response to Mr. Jacobs' question, you did say that a more efficient way of providing lower cost mortgage to first time buyers would be a tax credit or something of that nature, but you hedged on whether or not the administration would even support it.

Mr. CHAPOTON. That is correct, Mr. Matsui, because we do not think the subsidy is necessary. That is the point we have made throughout. But it would be a more efficient way of administering a subsidy.

Mr. MATSUI. Politically, do you think that you can win it unless you offer an alternative? I do not see a victory here for you.

Mr. CHAPOTON. As I pointed out in the statement, we recognize the realities here that a large number of the members on this side and on the other side support some extension of mortgage subsidy bonds. That is why we mention alternatives.

Mr. MATSUI. When do you think that you might be able to present an alternative, whether a credit or perhaps an outright authorization and appropriation that would equal or be close to the $2.8 billion in expected revenue losses? That way the subsidy could go directly to the homeowner rather than shared by everybody else.

Mr. CHAPOTON. You have to understand, most of that $2.8 billion is already built into the system by bonds that were issued in prior years. There is nothing we can do about it. So in 1984 we are talking about new costs of around only $0.1 billion with a 1-year extension of the sunset.

In answer to your question of whether we are going to actually propose something, I think our position is we do not want anything. We would obviously, if there is an extension in the works, think you ought to consider alternatives. We will work with the committee toward that end. And we also suggest, though, that the revenue problem could be partially taken care of, maybe even wholly taken care of, by putting limits at the same time on private purpose industrial development bonds and therefore to keep the overall volume down, which would take care of our revenue problem.

Mr. MATSUI. You indicated that you think that the current economic recovery would in fact alleviate the need for this type of housing financial assistance.

What do you expect in the next 2 years, 1984 and 1985, in terms of housing starts? For the last quarters, I guess, we were at 1.5 or 1.6 million. But do you think it is going to go up to 2 million, 1.8 million starts a year for the next 2 years?

Perhaps you can answer that, Deputy Secretary.

Mr. SULVETTA. I think it is a two-sided equation, demand for and the supply of housing will be around 1.6 to 1.8 million units.

Mr. MATSUI. Could you talk a little louder? I am sorry.

Mr. SULVETTA. I think it is a two-sided equation as to real demographic demands due to the baby boom and the supply of housing coming on line, and I feel it will be met at somewhere between 1.6 and 1.8 million units on an annual basis over the next 2 years.

Mr. MATSUI. If the interest rate should go up, let's say, 1 percent from what, 12½ to 13½ percent, will that change your prediction somewhat?

Mr. SULVETTA. There is always an interactive effect. In the short run we may have a brief decline in housing starts. I think the system will readjust if there is a small increase in interest rates.

Mr. MATSUI. Yes. The problem is, yesterday Mr. Donald Regan appeared before the subcommittee, and while we did not talk about interest rates, it sounds like we are not going to do anything with the deficits because there is a rather inflexible position being taken by the Treasury Department. I do not see any real assistance in that area, both by the Congress and by the administration. So you could assume that the interest rates, long-term rates, will probably go up in the next two or three quarters, and then you will have to rethink your projections. With that being the case, these creative financing mechanisms offered by the Government would be useful, at least for the next few years.

It seems to me that again, as in 1981, there is a lot of pipedreaming going on here rather than a realistic appraisal of what the economy will really show.

Mr. **Chapoton**. Well, Mr. Matsui, I must say we are not willing to assume that interest rates are going to go back up, and we do think, as I know the Secretary testified yesterday, that the deficits are a problem and that my proposal is on the table to deal with it, both on the spending side and in the outyears on the standby.

Mr. **Matsui**. While, I do not want to get into that with you, Mr. Chapoton, I think we have to be realistic. The administration is not going to be able to get what it wants, and we are not going to get what we want. Hence, I think these deficits are going to be there for a rather significant time period.

And that being the case, you ought to be thinking about what is going to happen to the housing market independent of the so-called rosy scenario that the administration been promoting for the past 2 years.

Mr. **Sulvetta**. In housing, we do have the graduated payment mortgage which, in our testimony, we indicated decreases the cost by 15 percent, and again, we have pending legislation as well.

Chairman **Rostenkowski**. Thank you, gentlemen, for joining us this morning.

The Chair would like to make the observation that today's schedule for this hearing must be adhered to. We have had this panel on for almost 2 hours. I am forced to ask Members to minimize the time of their questions so that time will be available to our guests for their answers.

The chair calls Dr. Rivlin and Director Birkle.

Welcome to the committee once again, Dr. Rivlin. I know that this might be your last hearing before this committee in your present capacity of Director of the Congressional Budget Office. On behalf of all my colleagues, I want to express appreciation for your service and for the cooperation that you have extended to those of us who have been here for a long time.

STATEMENT OF DR. ALICE M. RIVLIN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE, ACCOMPANIED BY PEARL RICHARDSON, ANALYST

Ms. **Rivlin**. Thank you very much, Mr. Chairman.

Chairman **Rostenkowski**. We appreciate all the service you have given to us.

With that, Dr. Rivlin, if you are ready to present your testimony, you may proceed.

Ms. **Rivlin**. Thank you very much, Mr. Chairman. I appreciate that.

I know you are running late, and I am also under a time constraint, so let me proceed as rapidly as possible and read only parts of the testimony.

Mr. Chairman, as you know, the use of tax-exempt State and local bonds for private purposes has grown sharply over the past several years, and they now account for about half of all new long term tax-exempt issues. Last year, tax-exempt bonds for private purposes amounted to nearly $43 billion, up from $28 billion in 1981.

During the next 5 years, subsidies to private entities from tax-exempt bonds will cost the Federal Government an average of about $13 billion a year. That, for example, is as much as the Federal Government is expected to spend on highways. It is more than the $12 billion a year in estimated Federal expenditures for assistance to public transit systems, wastewater treatment, water resources, airports, air traffic control, and municipal water supply systems combined.

The growing use of tax-exempt bonds for private purposes and the resulting costs raise a number of questions. One issue is whether subsidies for private purpose financing are still necessary, particularly in light of the business tax cuts enacted under the Economic Recovery Tax Act of 1981. A second is whether tax-exempt bonds are the most efficient means of providing subsidies, if any are necessary. And a third is whether the municipal bond market can continue to absorb large increases in private purpose financing. These issues are involved in the bills that the committee is considering today.

I deal with these issues in my prepared statement, but let me skip over the section on recent trends in tax-exempt bond financing because I think the committee is fully familiar with these trends and with the basic fact that issues for a variety of private purposes have grown very rapidly and are now about half of all tax-exempt financing, partially as a result the difference between taxable interest and nontaxable interest has narrowed substantially.

EFFECTS OF REPEALING THE SUNSET DATE

Picking up on page 5 of the testimony, let me deal with the effects of repealing the sunset date for single-family mortgage revenue bonds. As the sunset date for single-family mortgage revenue bonds approaches, the Congress must choose whether to let the authority terminate, extend it in its current form, or extend it in some altered form. If current law remains in effect, the authority for single-family mortgage bonds will expire at the end of the year. At that time, $39.4 billion in bonds will still be outstanding. The revenue losses associated with these bonds will total $1.5 billion in 1983 and will rise to $1.7 billion in 1984. Subsequently, the revenue loss will level off and begin to decline gradually. Total estimated revenue losses for fiscal year 1984 through 1988 amount to $7.9 billion.

If, on the other hand, the sunset date is repealed, revenue losses over the 1984–88 period are estimated at $10.7 billion. The $2.8 billion difference, however, understates the revenue effects of the continued use of the bonds. Every time a State or local government issues a tax-exempt bond, the Federal Government sustains revenue losses for as long as the debt is outstanding. Since most mortgage bonds have staggered or serial maturities of up to 30 years, a more appropriate way to look at costs is to calculate the amount of subsidy commitment over the life of the bonds.

To illustrate this point, although the additional revenue loss of not repealing mortgage revenue bonds would amount to an estimated $2.8 billion over the next 5 years, during the same period, the Federal Government would commit itself to about $24 billion in net new subsidies for single-family homes. Although the mortgage revenue bonds involve a multiyear commitment, the long-term costs of new issues do not appear in the budget documents. The full costs of most direct housing programs do appear in the budget, however, with an amount of budget authority expected to pay the full multiyear expense set aside at the time that new commitments are made.

EFFECTS OF PENDING LEGISLATION TO REDUCE THE USE OF IRB'S

Next, the effect of pending legislation to reduce the use of IRB's. Legislation now before the committee—H.R. 1635—proposes that assets financed with tax-exempt bonds be depreciated using the straight-line method over recovery periods that are longer than those now permitted under the accelerated cost recovery system. In addition, small issue IRB's would not be allowed for businesses with capital expenditures nationwide of more than $20 billion during the 3-year period before the bonds are issued, or with more than $20 million in outstanding small issues. Finally, the use of small issue IRB's for land acquisition would be prohibited.

These proposals would reduce the volume of pollution control bonds and small issue IRB's. The effect on pollution control bonds would be small, probably no more than 10 percent. The reason is that the depreciation recovery periods allowed under the bill are still short enough so that IRB's, coupled with straight-line depreciation, would result in greater tax savings than ACRS and conventional financing for every asset class, with the exception of 15-year real property.

In general, the choice between ACRS and IRB's will depend largely on a firm's ability to use depreciation deductions fully. In theory, the bill should have no effect on the use of pollution control bonds by firms that have sufficient income to use depreciation deductions. In practice, it would reduce the use of these bonds slightly because firms sometimes make decisions based on the amount of tax writeoffs during the early years of a project rather than on the total tax saving over the life of the project.

The bill would have a much greater effect on the use of small-issue IRB's because these bonds frequently provide financing for real property and land. Moreover, the proposed limit on capital expenditures will make it impossible for most Fortune-listed firms and some smaller ones to use the bonds. The CBO estimates that the effect of these measures would be to reduce the volume of small-issue IRB's by about 40 percent.

Although the bill would have little effect on pollution control financing and none on private hospital or student loan bonds, it would result in immediate revenue gains. These revenue gains will rise from $100 million in fiscal year 1984 to approximately $1.4 billion in fiscal year 1988.

POLICY ISSUES

Both of the bills now pending before the committee raise the same policy issues: Are the subsidies necessary? Are they efficient? And what effect do they have on the municipal bond market?

On the need for subsidies, at present, firms that avail themselves of tax-exempt financing can take straight-line depreciation over the ACRS recovery periods. Unless the Congress has a special reason for providing industry with subsidies so deep that they result in a negative tax rate, the idea of trading shorter depreciation recovery periods for tax-exempt financing would appear to be equitable. Currently, the combination of IRB financing and ACRS recovery periods for 3-year and 5-year equipment results in greater tax savings than would occur if the investment were immediately recovered in full, or expensed. This can cause distortion in capital resource allocation.

Regarding single-family housing bonds, the issues have more to do with the effectiveness of current programs and the desire of the Congress to provide housing subsidies. The experience under the targeting provisions of the Mortgage Subsidy Bond Act has been mixed. Some housing agencies and local governments have targeted their programs as much as possible on economically distressed areas and low-income home buyers, while others have sought to minimize the impact of the targeting provisions in order to improve the financial backing for the bonds and to reassure bondholders. Roughly half of the recipients of loans appear to be low- to moderate-income households—that is, with incomes at or below the median for their areas. The Congress has to determine whether to continue subsidies, and if so, whether to do it under the current program.

If subsidies are necessary, it is questionable whether tax-exempt bonds are the best way to provide them. Direct subsidies are usually a less expensive and more efficient alternative. A CBO analysis undertaken a few years ago indicated that in the case of tax-exempt mortgage bonds, approximately 54 percent of the subsidy went to the home buyers. Most of the remainder went to bondholders and, to a lesser extent, intermediaries, including issuers, underwriters, and bond counsel.

Tax-exempt bonds often result in other inefficiencies. In the case of pollution control bonds, for example, tax-exempt financing is available only for "end-of-the-pipe" capital expenditures, which discourages selection of other, possibly more effective, solutions to the underlying problem, such as the use of less polluting raw materials or production processes. In the case of hospitals, targeting direct subsidies to areas with shortages of adequate facilities may be a much less costly and more efficient means of providing assistance than the continued universal availability of tax-exempt financing.

And; then there is the effect on the municipal bond market. Although municipal bond rates declined steadily through most of 1982, the relative advantage of tax-exempt financing diminished. Tax-exempt rates, which historically have tended to be approximately 30 percent lower than conventional rates, are now only 20 percent lower. The growth in private-purpose financing is partially responsible for the erosion in the savings normally associated with tax-exempt bonds. The reduction in the maximum tax from 70 to 50 percent and the expansion of other tax-favored investment options in the 1981 act have lessened individual and institutional demand for tax-exempt bonds. Despite these structural changes, cutbacks in the volume of tax-exempt bonds for private purposes can only reduce the cost of financing public projects.

POLICY ALTERNATIVES

The alternatives before the Congress are to maintain current law, to repeal the sunset date on mortgage revenue bonds, or to continue housing and industrial revenue bond subsidies in some altered form. If the use of mortgage bonds is continued, the Congress could target the subsidy more narrowly on low-and moderate-income households by placing Federal income limits on home-buyers, or by limiting the subsidy to home-buyers who forgo the deduction of mortgage interest from taxable income. Although income limits would concentrate the subsidy on those home-buyers most in need of financial aid, they probably would not reduce the volume of mortgage bonds significantly unless they were very low. Income ceilings would also involve administrative problems of monitoring compliance and making adjustments for regional cost of living variations. Limiting the subsidy to home-buyers who forgo the deduction of mortgage interest could have a greater effect on volume. It would also be an administratively simpler way to target assistance to lower income households. Taxpayers in higher marginal brackets would be better off taking the interest deduction and would automatically exclude themselves from the program. Lower income homeowners benefit little or not at all from mortgage interest deductions and so would prefer the subsidy.

Whether or not the Congress repeals the sunset provision in the Mortgage Subsidy Bond Tax Act of 1980, further restrictions in the uses of tax-exempt bonds for private purposes may be in order. These restrictions may take the form outlined in the bill now before the committee. However, if the depreciation recovery periods were longer than those proposed in the bill, the volume of IRB's could be reduced more substantially. Last year the administration proposed recovery periods ranging from 5 to 35 years.

The Congress may also wish to consider subjecting IRB's to State-by-State volume limits. At present, only mortgage bonds are subject to such limits. For the sake of simplicity, the limits would probably be best based on population. One alternative would be to set State-by-State limits for all private purpose bonds, which would permit the States to decide for themselves how to allocate subsidies among housing, health care, and private industrial and commercial facilities. Limits could be set at the current national volume or lower, or they could gradually be reduced. If limits were set to result in a $10 billion a year reduction in bond issues beginning in 1984, the revenue gains in fiscal years 1984 through 1988 would amount to about $2 billion. These savings could be used to reduce the deficit. Alternatively, they could be used to provide additional Federal assistance to help States and localities meet their infrastructure needs, which under current policies would require nonfederal outlays averaging about $25 billion a year.

In conclusion, Mr. Chairman, tax-exempt financing for private purposes has been an issue for several years. The legislation before the committee raises the question of whether the current federal subsidies continue to be necessary, clearly a question that should be addressed.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF ALICE M. RIVLIN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. Chairman, the use of tax-exempt state and local bonds for private purposes has grown sharply over the past several years, and they now account for about half of all new long-term, tax-exempt issues. Last year, tax-exempt bonds for private purposes amounted to nearly $43 billion, up from about $28 billion in 1981 (see Table 1).

During the next five years, subsidies to private entities from tax-exempt bonds will cost the federal government an average of about $13 billion a year. That, for example, is as much as the federal government is expected to spend on highways. It is more than the $12 billion a year in estimated federal expenditures for assistance to public transit systems, wastewater treatment, water resources, airports, air traffic control and municipal water supply systems combined.

The growing use of tax-exempt bonds for private purposes and the resulting costs raise a number of questions. One issue is whether subsidies for private-purpose financing are still necessary, particularly in light of the business tax cuts enacted under the Economic Recovery Tax Act of 1981. A second is whether tax-exempt bonds are the most efficient means of providing subsidies, if any are necessary. A third is whether the municipal bond market can continue to absorb large increases in private-purpose financing. These issues are involved in the bills that the Committee is considering today.

My testimony this morning will deal with four matters:

Recent trends in the use of tax-exempt bonds for private purposes;

The likely effect of the bill to repeal the sunset date on mortgage revenue bonds for single-family homes;

TABLE 1. VOLUME OF LONG-TERM TAX-EXEMPT ISSUES BY TYPE OF ISSUE, 1975-1982
(In billions of dollars)

	1975	1976	1977	1978	1979	1980	1981	1982
Total Long-Term Tax-Exempt Issues	32.4	35.7	48.0	49.9	48.7	55.2	57.9	87.6
Total Private-Purpose Tax-Exempt Issues[a]	6.8	9.0	14.3	16.7	25.3	29.3	27.9	42.8
Housing bonds	1.5	2.7	4.5	7.1	12.1	14.0	5.6	14.4
Single-family MSBs	0.0	0.7	1.0	3.4	7.8	10.5	3.6	8.8
Multifamily IRBs	0.9	1.4	2.9	2.5	2.7	2.2	1.1	5.1
Veterans' GO bonds	0.6	0.6	0.6	1.2	1.6	1.3	0.9	0.5
Private hospital bonds	1.5	2.0	3.6	2.4	2.6	2.7	3.9	7.3
Student loan bonds	0.0	0.1	0.1	0.3	0.6	0.5	1.1	1.8
Pollution control IRBs	2.5	2.7	3.9	3.5	2.9	2.9	4.7	6.6
Small issue IRBs	1.3	1.5	2.2	3.4	7.1	9.2	12.6	12.7
Refunding Bonds	0.9	3.5	9.6	9.3	1.9	1.6	1.2	3.8
Other Long-Term Tax-Exempt Issues[b]	24.7	23.2	24.1	23.9	21.5	24.3	28.8	41.0

NOTE: MSB = mortgage subsidy bond; IRB = industrial revenue bond; GO bond = general obligation bond.

SOURCES: Data for housing bonds are from the Department of Housing and Urban Development, Office of Financial Management. Data for total pollution control, hospital, and other long-term tax-exempt bonds are from the *Bond Buyer*. (Private hospital bonds represent approximately 75 percent of all hospital bond issues.) Data on student loan bonds come from the Department of the Treasury, Office of Tax Analysis. Small issue IRB data are based on CBO surveys.

a. The total does not include private-purpose debt for airport and port facilities, industrial parks, sports facilities, trade show and convention centers, sewage and solid waste disposal facilities, mass commuting and hydroelectric generating facilities that could not be identified or classified.

b. Includes state and local government financing for public facilities and private purpose debt that could not be identified or classified.

The likely effects of the bill to limit the use of industrial revenue bonds; and
Some other alternatives that the Congress may wish to consider.

TRENDS IN THE USE OF TAX-EXEMPT BONDS FOR PRIVATE PURPOSES

Tax-exempt financing for private entities has been growing much more rapidly than tax-exempt financing for traditional public purposes. In 1975, tax-exempt bonds to provide low-cost financing to private entities represented only 20 percent of all new long-term issues. Since 1979, however, these bonds have accounted for about 50 percent of the market. As a percentage of GNP, tax-exempt bonds for private purposes more than tripled between 1975 and 1982 (see Figure 1). At the same time, bonds for public purposes declined as a share of GNP by more than 10 percent. In real dollars (adjusted for inflation), the volume of tax-exempt bonds for public projects in 1982 was about 5 percent higher than it had been in 1975, whereas tax-exempt financing for private entities was a whopping 300 percent higher (see Table 2).

Industrial revenue bonds (IRBs) are the primary mechanism for providing tax-exempt financing for private investment in plant and equipment. IRBs may be used without regard to issue size to finance pollution control equipment, private hospitals, airport and port facilities, sports facilities, convention centers, and industrial parks. Small issue IRBs, which may not exceed $10 million, may be used to finance plant and equipment for other unspecified private business purposes. Mortgage revenue bonds provide low-cost financing for both single-family and multifamily housing.

Small issue IRB's.—Small issue IRBs, which are used to finance a wide variety of facilities, account for the largest share of all tax-exempt bonds floated for private purposes. All 50 states permit the use of small issues. Between 1975 and 1981, small issue sales increased from $1.3 billion to $12.6 billion. A preliminary CBO survey indicated that the volume of sales in 1982 increased only slightly to $12.7 billion; it is likely, however, that the final figure will be higher.

Figure 1.

Tax-Exempt Bonds as a Percentage of GNP

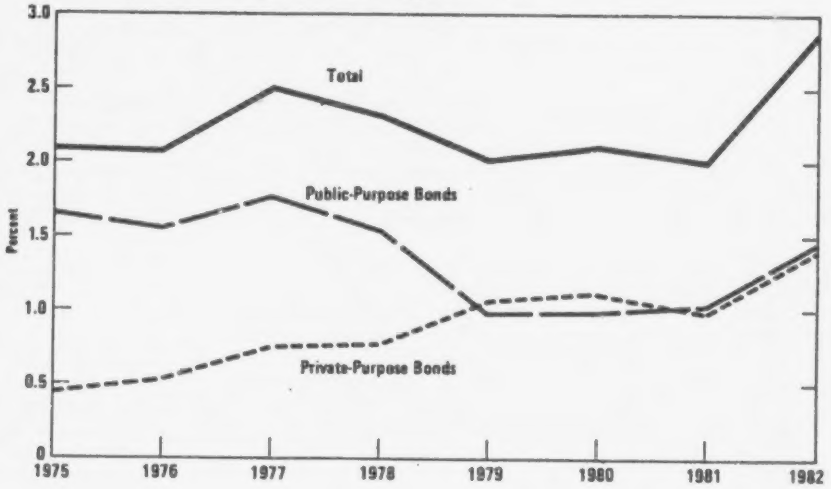


TABLE 2. VOLUME OF LONG-TERM TAX-EXEMPT ISSUES IN REAL DOLLARS, 1975-1982
(In billions of 1975 dollars)

	1975	1976	1977	1978	1979	1980	1981	1982
Total Long-Term Tax-Exempt Issues[a]	31.5	32.1	36.2	35.7	37.8	39.6	38.3	53.4
Private-Purpose Tax-Exempt Issues[b]	6.8	9.0	13.5	14.7	20.5	21.7	18.9	27.3
Other Long-Term Tax-Exempt Issues[c]	24.7	23.2	22.7	21.0	17.4	18.0	19.5	26.1

a. Excludes refunding issues.

b. The total does not include private-purpose debt for airport and port facilities, industrial parks, sports facilities, trade show and convention centers, sewage and solid waste disposal facilities, mass commuting and hydroelectric generating facilities that could not be identified or classified.

c. Includes state and local government financing for public facilities and private-purpose debt that could not be identified or classified.

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) imposed some restrictions on the use of small issue IRBs, but few state development officials contacted by CBO anticipated any major disruptions as a result.[1] CBO's analysis of the TEFRA restrictions was that they would have a minimal effect on the volume of small issues. Accordingly, economic recovery, especially if coupled with rising interest rates, will result in the continued growth in the use of small issue IRBs.

Pollution control bonds.—Sales of tax-exempt pollution control bonds increased by 40 percent between 1981 and 1982, reaching $6.6 billion. These bonds finance approximately 40 percent of all private investment in pollution control equipment. Since the exemption for pollution control equipment antedated the passage of federal environmental control laws, it may initially have served as an incentive to induce firms to undertake pollution abatement measures voluntarily. Today, because federal regulations are so highly prescriptive, the availability of tax-exempt bonds has only limited influence on a company's decision to invest in pollution control equipment.

Private hospital bonds.—The volume of tax-exempt bonds used to finance private hospital construction increased a hefty 87 percent from $3.9 billion in 1981 to $7.3 billion in 1982. Tax-exempt bonds finance about half of all new hospital construction. The necessity of providing subsidies for new hospital construction has come into question because at present the United States has a surplus of hospital beds. Consequently, direct federal subsidies for hospital construction have been cut back sharply in recent years. Despite a national surplus, some areas might lack adequate hospital facilities, making selective use of some form of subsidy worthy of consideration.

Mortgage revenue bonds.—State housing agencies began issuing tax-exempt bonds for single-family housing in the early 1970s, and local governments and housing agencies first issued them in 1978. Two years later, in response to a surge in these issues, the Congress passed the Mortgage Subsidy Bond Tax Act of 1980. This legislation sharply restricted the use of single-family housing bonds in order to reduce revenue losses and to target assistance more effectively. The act set limits on state bond volume and home purchase prices, introduced targeted area requirements, and restricted the subsidy principally to first-time homebuyers. It also contained a sunset provision that ends the use of bonds for single-family homes after 1983.

After rising sharply from $1.5 billion in 1975 to $14.0 billion in 1980, total housing bond volume dropped to $5.6 billion in 1981. The drop in volume resulted largely from the federal restrictions enacted in 1980 and the high interest rates prevailing during the year. As market conditions improved during the summer of 1982, many jurisdictions were able to issue bonds more easily. In 1982, tax-exempt bonds for housing finance totaled $14.4 billion—$8.8 billion for single-family housing, $5.1 billion for multifamily rental housing, and $0.5 billion for veterans' housing.

THE EFFECTS OF REPEALING THE SUNSET DATE FOR SINGLE-FAMILY MORTGAGE REVENUE BONDS

As the sunset date for single-family mortgage revenue bonds approaches, the Congress must choose whether to let this authority terminate, extend it in its current form, or extend it in some altered form. If current law remains in effect, the authority for single-family mortgage bonds will expire at the end of the year. At that time, $39.4 billion in bonds will still be outstanding. The revenue losses associated with these bonds will total $1.5 billion in 1983 and will rise to $1.7 billion in fiscal year 1984. Subsequently, the revenue loss will level off and begin to decline gradually. Total estimated revenue losses for fiscal years 1984 to 1988 amount to $7.9 billion.

If, on the other hand, the sunset date is repealed, revenue losses over the 1984–1988 period are estimated at $10.7 billion. The $2.8 billion difference understates the revenue effects of the continued use of the bonds, however. Every time a state or local government issues a tax-exempt bond, the federal government sustains revenue losses for as long as the debt is outstanding. Since most mortgage bonds have staggered or serial maturities of up to 30 years, a more appropriate way to look at costs is to calculate the amount of subsidy commitment over the life of the bonds.

To illustrate this point, although the additional revenue loss of not repealing mortgage revenue bonds would amount to an estimated $2.8 billion over the next five fiscal years, during the same period the federal government would commit itself to $24.1 billion in net new subsidies for single-family homes (see Table 3). Although mortgage revenue bonds involve a multiyear commitment, the long-term costs of new issues do not appear in budget documents. The full costs of most direct housing assistance programs do appear in the budget, however, with an amount of budget authority expected to pay the full multiyear expense set aside at the time that new commitments are made.

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[1] TEFRA requires IRB issuers to make quarterly reports to the Internal Revenue Service (IRS); requires an approval process involving either a public hearing and approval by an elected official or a public referendum; reduces, with certain exceptions, cost recovery deductions for IRB-financed property; eliminates the use of small issue IRBs to finance certain facilities, such as golf courses and racquetball clubs; and repeals the exemption for small issue IRBs after 1986.

TABLE 3.—NET NEW SINGLE-FAMILY MORTGAGE BOND REVENUE LOSSES FROM REPEAL OF THE SUNSET PROVISION, 1984–88

[In billions of dollars, by calendar year except as noted]

	1984	1985	1986	1987	1988	Total [1]
Estimated bond issues	10.4	13.0	16.9	20.4	23.6	84.3
Federal subsidy over the term of bonds	3.5	4.2	5.0	5.4	5.9	24.1
Present value of the subsidy commitment [2]	1.7	2.1	2.6	2.6	2.9	11.8
Fiscal year revenue losses	0.1	0.2	0.5	0.8	1.2	2.8

[1] Totals may not add because of rounding.

[2] The present value is the multiyear stream of revenue losses discounted for the fact that losses in the later years have a lower current cost than those in the early years.

THE EFFECTS OF PENDING LEGISLATION TO REDUCE THE USE OF IRB'S

Legislation now before the Committee (H.R. 1635) proposes that assets financed with tax-exempt bonds be depreciated using the straight-line method over recovery periods that are longer than those now permitted under the Accelerated Cost Recovery System (ACRS).[2]

In addition, small issue IRB's would not be allowed for business with capital expenditures nationwide of more than $20 million during the three-year period before the bonds are issued, or with more than $20 million of outstanding small issues. Finally, the use of small issue IRBs for land acquision would be prohibited.

These proposals would reduce the volume of pollution control bonds and small issue IRBs. The effect on pollution control bonds would be small—probably no more than 10 percent. The reason is that the depreciation recovery periods allowed under the bill are still short enough so that IRBs coupled with straight-line depreciation would result in greater tax savings than ACRS and conventional financing for every asset class, with the exception of 15-year real property (see Table 4). In general, the choice between ACRS and IRBs will depend largely on a firm's ability to use deprication deductions fully. In theory, the bill should have no effect on the use of pollution control bonds by firms that have sufficient income to use depreciation deductions. In practice, it would reduce the use of these bonds slightly because firms sometimes make decisions based on the amount of tax writeoffs during the early years of a project, rather than on total tax savings over the life of the project.

The bill would have a much greater effect on the use of small issue IRBs because these bonds frequently provide financing for real property and land. Moreover, the proposed limit on capital expenditures will make it impossible for most Fortune-listed firms—and some smaller ones—to use the bonds. The CBO estimates that the effect of these measures would be to reduce the volume of small IRBs by about 40 percent.

Although the bill would have little effect on pollution control financing and none on private hospital or student loan bonds, it would result in immediate revenue gains. These revenue gains will rise from $100 million in fiscal year 1984 to approximately $1.4 billion in fiscal year 1988.

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[2] The proposed depreciation recovery periods are 5 years for equipment in the 3-year class; 8 years for equipment in the 5-year class; 15 years for equipment in the 10-year class; 22 years for 15-year public utility property; and 25 years for 15-year real property, with the exception of low-income housing, which would remain eligible for ACRS deductions.

TABLE 4.—PRESENT VALUE OF AFTER-TAX SAVINGS FROM ALTERNATIVE METHODS OF FINANCING AND DEPRECIATING A $10 MILLION INVESTMENT IN EQUIPMENT OR REAL PROPERTY [1]

[In thousands of dollars]

Tax provision	3-yr. equipment [2]	5-yr. equipment [3]	10-yr. equipment [4]	15-yr. public utility property [4]	15-yr. real property [5]
Expensing	4,600	4,600	4,600	4,600	4,600
ACRS, ITC and conventional financing	4,097	3,875	3,310	2,860	3,070
Current law alternative (straight-line depreciation over ACRS recovery period)	4,775	4,752	4,359	4,035	3,715
H.R. 1635 alternative (straight-line depreciation over 5- to 25-year recovery periods)	4,439	4,353	3,888	3,563	3,051
Administration's 1982 proposal (straight-line depreciation over 5- to 35-year recovery periods)	4,439	3,920	3,259	3,022	2,649

[1] Assumes a 3 percentage point differential between tax-exempt and taxable interest rates and a 46 percent corporate tax rate. The terms of the bonds vary, as indicated, with the type of property being financed. Tax savings are stated in present value terms, using a 10 percent discount rate. Present value discounting is a procedure used to assign a value to funds that will be received at specific future dates. It is designed to take into account the fact that the promise of funds in the future is less valuable than having the money presently in hand.

[2] Assumes a 7-yr. bond term.

[3] Assumes a 10-yr. bond term.

[4] Assumes a 15-yr. bond term.

[5] Assumes a 20-yr. bond term. The ITC is inapplicable. Low-income housing is excluded.

POLICY ISSUES AND ALTERNATIVES

Both of the bills now pending before the Committee raise the same policy issues: Are subsidies necessary? Are they efficient? And what effect do they have on the municipal bond market?

The need for subsidies.—At present, firms that avail themselves of tax-exempt financing can take straight-line depreciation over the ACRS recovery periods. Unless the Congress has a special reason for providing industy with subsidies so deep that they result in a negative tax rate, the idea of trading shorter depreciation recovery periods for tax-exempt financing would appear to be equitable. Currently, the combination IRB financing and ACRS recovery periods for three-year and five-year equipment results in greater tax savings than would occur if the investment were immediately recovered in full (or "expensed"). This can cause distortion in capital resource allocation.

Regarding single-family housing bonds, the issues have more to do with the effectiveness of current programs and the desire of the Congress to provide housing subsidies. The experience under the targeting provisions of the Mortgage Subsidy Bond Act has been mixed. Some housing agencies and local governments have targeted their programs as much as possible on economically distressed areas and low-income homebuyers, whereas others have sought to minimize the impact of the targeting provisions in order to improve the financial backing for the bonds and to reassure bondholders. Roughly half of the recipients of loans appear to be low- to moderate-income households—that is, with incomes at or below the median for their areas. The Congress has to determine whether to continue subsidies, and if so, whether to do so under the current program.

The efficiency of tax-exempt bond subsidies.—If subsidies are necessary, it is questionable whether tax-exempt bonds are the best way to provide them. Direct subsidies are usually a less expensive and more efficient alternative. A CBO analysis undertaken a few years ago indicated that, in the case of tax-exempt mortgage bonds, approximately 54 percent of the subsidy went to the homebuyers. Most of the remainder went to bondholders and, to a lesser extent, intermediaries, including issuers, underwriters, and bond counsel.

Tax-exempt bonds often result in other inefficiencies. In the case of pollution control bonds, for example, tax-exempt financing is available only for "end-of-pipe" capital expenditures, which discourages selection of other, possibly more effective, solutions to the underlying problem—such as the use of less polluting raw materials or production processes. In the case of hospitals, targeting direct subsidies to areas with shortages of adequate facilities may be a much less costly and more efficient means of providing assistance than the continued universal availability of tax-exempting financing.

The effects of the municipal bond market.—Although municipal bond rates declined steadily throughout most of 1982, the relative advantage of tax-exempt financing diminished. Tax-exempt rates, which historically have tended to be approximately 30 percent lower than conventional rates, are now only 20 percent lower. The growth in private-purpose financing is partially responsible for the erosion in the savings normally associated with tax-exempt bonds. The reduction in the maximum tax from 70 to 50 percent and the expansion of other tax-favored investment options in the 1981 Tax Act have lessened individual and institutional demand for tax-exempt bonds. Despite these structural charges, cutbacks in the volume of tax-exempt bonds for private purposes can only reduce the cost of financing public projects.

Policy alternatives.—The alternative before the Congress are to maintain current law, to repeal the sunset date on mortgage revenue bonds, or to continue housing and industrial revenue bond subsidies in some altered form. If the use of mortgage bonds is continued, the Congress could target the subsidy more narrowly on low- and moderate-income households by placing federal income limits on homebuyers or by limiting the subsidy to homebuyers who forgo the deduction of mortgage interest from taxable income. Although income limits would concentrate the subsidy on those homebuyers most in need of financial aid, they probably would not reduce the volume of mortgage bonds significantly unless they were very low. Income ceilings would also involve administrative problems of monitoring compliance and making adjustments for regional cost-of-living variations. Limiting the subsidy to homebuyers who forgo the deduction of mortgage interest could have a greater effect on volume. It would also be an administratively simpler way to target assistance to lower-income households. Taxpayers in higher marginal brackets would be better off taking the interest deduction and would automatically exclude themselves from the program. Lower-income homeowners benefit little or not at all from mortgage interest deductions and so would prefer the subsidy.

Whether or not the Congress repeals the sunset provision in the Mortgage Subsidy Bond Tax Act of 1980, further restrictions on the uses of tax-exempt bonds for private purposes may be in order. These restrictions may take the form outlined in the bill now before the Committee; however, if the depreciation recovery periods were longer than those proposed in the bill, the volume of IRBs could be reduced more substantially. Last year, the administration proposed recovery periods ranging from 5 to 35 years.

The Congress may also wish to consider subjecting IRBs to state-by-state volume limits. At present, only mortgage bonds are subject to such limits. For the sake of simplicity, the limits would probably best be based on population. One alternative would be to set state-by-state limits for all private-purpose bonds, which would permit the states to decide for themselves how to allocate subsidies among housing, health care, and private industrial and commercial facilities. Limits could be set at the current national volume, or lower, or they could be gradually reduced. If limits were set to result in a $10 billion a year in bond issues beginning in 1984, the revenue gains in fiscal years 1984-1988 would amount to about $2 billion. These savings could be used to reduce the deficit. Alternatively, they could be used to provide additional federal assistance to help states and localities meet their infrastructure needs, which under current policies will require nonfederal outlays averaging $25 billion a year.

In conclusion, Mr. Chairman, tax-exempt financing for private purposes has been an issue for several years. The legislation before the Committee seems to be trying to address the question of whether the current federal subsidies continue to be necessary. Clearly, the question needs to be addressed.

Mr. GIBBONS [presiding]. Thank you, Dr. Rivlin. We are going to take you first because we know you have a 12 o'clock appointment.

Do members have any questions for Dr. Rivlin?

Mr. Pickle.

Mr. PICKLE. Dr. Rivlin, I thank you for your testimony, and I appreciate it both with respect to MRB's and industrial development bonds which I am particularly interested in.

I note that one of the recommendations you have that you said that we might extend the depreciation period even further than what is in the bill before us, H.R. 1635.

Do you have any recommendation of the amount of extension? In other words, would it make it just straight line, or do you have a suggestion, other than just it might be extended further?

Ms. RIVLIN. No. We really just meant to suggest that the longer you make the period, the more you will reduce the incentive to use these kinds of bonds. The administration did make such a proposal last year. But we do not make recommendations on specifics like that or, indeed, on anything. But we would be glad to look at the options for you.

Mr. PICKLE. One more question with respect to the limits.

You said if limits were set to result in a $10 billion reduction in bond issues beginning in 1984, is that the total amount that you would say limit, or say limit it to not over $10 billion a year? Is that what you mean? Or reduce it down to that level?

Ms. RIVLIN. No; we were just giving an illustration. You could set the limit at the current level. That would be one place. Or you could set it at $10 billion less than the current level, which is what that illustration suggested.

Mr. PICKLE. And my question, do you have a sum that you are recommending to us——

Ms. RIVLIN. No, sir.

Mr. PICKLE [continuing]. Or are you just—that was just an example?

Ms. RIVLIN. No, that is just a example.

Mr. PICKLE. Well, I thank you for your testimony, and I think it is very helpful to us.

Mr. GIBBONS. Mr. Duncan.

Mr. DUNCAN. I have no questions.

Mr. GIBBONS. Mr. Downey.

Mr. DOWNEY. Thank you, Mr. Chairman.

I just want to say that, Dr. Rivlin, it has been a pleasure to serve with you, both as a member of the Ways and Means Committee and a member of the Budget Committee. When I learned that you were not a card-carrying Keynesian economist, I even had greater respect for you, and having said all of that, I am a little troubled by your testimony on one particular area, and that is in the area of mortgage revenue bonds and the cost that you estimate is actually used by the mortgagor, the amount of money.

You said that in a study you did several years ago, that you found that, what, 51 or 54 percent of the money actually went for mortgages? Is that your testimony?

Ms. RIVLIN. Yes. About half of the subsidy actually goes to the homeowner. The rest of it goes either to the bondholder or to other intermediaries.

Mr. DOWNEY. Dr. Rivlin, that contradicts everything else that I have ever read or seen on this, including a recent GAO report where they assumed that only 87 percent of the funds raised by bonds would be used by mortgages, and the Treasury Department that says 67 percent would be used directly by mortgages, and a University of Chicago study that says 93 percent of it will be used by—directly for mortgages.

How do you account for the disparity between your figures and those of the GAO, the Treasury and the University of Chicago?

Ms. RIVLIN. I do not think we have differences with the Treasury or with the Joint Tax Committee on that, on the revenue loss anyway.

Mr. DOWNEY. Let me just try to——

Ms. **Rivlin**. We do have differences with the University of Chicago study, which essentially has a different estimating method from that used by the Treasury and our analysts.

Let me ask Mrs. Richardson, who knows more about this than I do, to comment on those methods.

Mr. **Downey**. Let me make sure that you understand the Treasury has not said that 51 or 54 percent is the amount used. Their testimony by Mr. Chapoton was that two-thirds of the money would be used, and that is the lowest estimate I have heard. Even GAO is higher than that. So in that context, I would like to hear your answer.

Mrs. **Richardson**. These estimates of the efficiency of bonds can vary from time to time and from study to study. The study that Dr. Rivlin mentioned in her testimony was an analysis that was done by CBO staff in 1979. We would be happy to send you a copy of it.

Mr. **Downey**. No, I am not interested in 1979 because I think that circumstances have changed enough so that that data, with all respect, is probably outdated and useless to us right now.

Mrs. **Richardson**. That particular study compared the efficiency of mortgage subsidy bonds with the section 235 program. It found the 235 program to be 90-percent efficient. It found mortgage subsidy bonds at that time to be 54-percent efficient. Tha is not to say that a study done today might not show mortgage subsidy bonds to be somewhat more efficient.

Mr. **Downey**. I see. So it was a comparison——

Mrs. **Richardson**. Depending upon the time and market conditions, the percentage of efficiency that you come up with could at times be 50 percent. It could go up to about two-thirds. And in that sense, there is no real contradiction between the numbers that we are citing and the numbers that Treasury has cited.

Mr. **Downey**. Except that your comparison was with what—the 235 housing?

Mrs. **Richardson**. Our 1979 study compared mortgage subsidy bonds with the Section 235 program at that time.

Mr. **Downey**. How much money is in the budget for the 235 housing this year?

Mrs. **Richardson**. That program is now phased out.

Mr. **Downey**. Thank you.

Can you give me some idea of——

Mr. **Pickle**. Would you yield in that connection?

I would hope that we might ask the Joint Tax Committee to give us a summary or appraisal of the various estimated costs of the mortgage subsidy bonds. Dr. Rivlin has said about half of it goes to the home buyer and the other half goes to bondholders and others. I had heard that it was 4 to 1, that is, that the home buyer gets $1 to $4 going out.

Mr. Chapoton uses a little different figure this morning. I do not know what the GAO will testify. But I thank the gentleman. You are raising a good question. We ought to get something that we can believe is factual and I would hope they could give us that figure.

Mr. **Downey**. If I could borrow your minute, I would be happy to extend you more time, but I have one other question about the revenue loss estimates per billion dollars of bonds.

What do you estimate, Dr. Rivlin, the cost per billion dollars of bonds is to the Treasury?

Mrs. **Richardson**. I am sorry, but we really do not have such a number. It would confuse rather than enlighten.

Mr. **Downey**. Who would it confuse?

Mrs. **Richardson**. I think it would be misleading.

Mr. **Downey**. Why?

Mrs. **Richardson**. At any given point the revenue estimates for losses from tax-exempt bonds are a product of the volume of bonds issued, the interest rates on alternative taxable bonds, and the marginal tax bracket of new purchasers of tax-exempt bonds, who are making changes on their asset holdings to include a larger portion of equity of tax-exempt securities.

Since interest rates vary widely and they have fluctuated a great deal in recent years, it is very hard to say that per billion dollars of bonds issued, you have *x* millions of dollars of revenue losses.

Mr. **Downey**. Well, notwithstanding the difficulty and the potential confusion for those of us of small mind, why can't CBO do the analysis anyway for 1982 and 1984, give us a projection?

Mrs. **Richardson**. We would be happy to do so.

[The following was subsequently received:]

U.S. Congress,
Congressional Budget Office,
Washington, D.C.

Hon. Thomas Downey,
U.S. House of Representatives, Washington, D.C.

Dear Congressman: At last week's hearings, you raised several questions about the revenue losses from tax-exempt bonds and the efficiency of these subsidies. The following information is intended to respond more fully to your questions than was possible at the hearings. I hope it does so.

REVENUE LOSSES

The calculations of losses from tax-exempt bonds are a product of the average amount of outstanding new issues each year, the interest rate on alternative taxable bonds in the same year, and the marginal tax bracket of investors in new issues of tax-exempt bonds. In the past few years, interest rates have fluctuated widely. From 1979 to 1982, the average annual revenue loss for each $1 billion of new issues of mortgage subsidy bonds has ranged from $22 million to $37 million.

The revenue loss calculations, shown in the table below, assume $1 billion in new issues and a 30 percent marginal tax rate of new investors in tax-exempt bonds. Taxable interest rates are based on Moody's average corporate bond rate. All of these calculations for mortgage subsidy bonds include an offset for the lower mortgage interest deductions taken by the loan recipients.

REVENUE LOSS FROM EACH $1 BILLION IN NEW TAX-EXEMPT BOND ISSUES

Year	Taxable interest rate (in percent)	Revenue loss (in millions of dollars)
1979	10.12	21.9
1980	12.75	29.1
1981	15.06	36.6
1982	14.94	35.0
1983 [1]	11.33	25.3
1984 [1]	10.14	20.8

[1] CBO projection. The 1984 estimate assumes repeal of the sunset provision.

At the hearing a question was raised about the assumptions underlying the Treasury's estimates of revenue losses from tax-exempt bonds. CBO, the Joint Committee on Taxation, and Treasury use the same method in estimating revenue losses from tax-exempt bonds. As noted above, these estimates are the product of the average amount of outstanding new issues of tax-exempt bonds during each calendar year, the interest rate on alternative taxable loans in the same calendar year and the marginal tax bracket of investors in new issues of tax-exempt bonds. The underlying assumption is that tax-exempt financing ultimately displaces taxable financing. New issues of tax-exempt securities cause investors to shift their asset holdings. Some investors move from taxable bonds, which are taxed at ordinary income rates, to equity, which is taxed at lower capital gains rates. Others may move from equity to tax-exempt bonds. In determining revenue losses, the significant measure is the net change in all portfolio holdings resulting from tax-exempt bond issues. Accordingly, the relevant marginal tax bracket is a combination of the tax rates of the last investor who switches from partially taxable holdings, such as equity, to tax-exempt holdings and the investor who moves from fully taxed to partially taxed holdings. This combined tax rate roughly corresponds to the spread between tax-exempt and taxable interest rates, which historically has averaged 30 percent and now is closer to 20 percent. (In contrast, the average marginal tax bracket of all holders of tax-exempt securities is closer to 40 percent. The lower rate serves to isolate the effects of revenues of a fairly small increment of the stock of tax-exempt debt outstanding. Conversely, for measuring the revenue loss from the entire stock of outstanding tax-exempt bonds, the higher rate is more appropriate.)

If the current differential between tax-exempt and taxable holdings remains at 20 percent, we would begin to use that rate in our revenue loss calculations. At present, we think such a move would be premature. We know that historically the differential has been 30 percent. Last year, it went down to 20 percent, but, if profits of banks and casualty insurance companies were to increase, demand for tax-exempt bonds could go up and the differential between tax-exempt and taxable rates could become wider.

Two University of Chicago economists, Roger Kormendi and thomas Nagle, have taken issue with out method of estimating revenue losses from tax-exempt bonds. They point out that investment decisions are based not only on after-tax yields but also on return relative to risk. Consequently, lower- and moderate-income households, nonprofit institutions, pension funds and life insurance companies, which may be nontaxable or in low marginal tax brackets, will nevertheless purchase partially taxable assets, such as equity. These observations lead Kormendi and Nagle to use a much lower tax rate than CBO or the Joint Committee in computing revenue losses. The tax rate that they use is roughly 10 percent, compared with the CBO/Joint Tax Committee/Treasury rate of 30 percent. Accordingly, Kormendi and Nagle come up with considerably lower estimates of revenue losses.

Although we would agree that return relative to risk plays a role in investment decisions, we have a problem in the way Kormendi/Nagle take risk considerations into account. First, their data come from a survey of asset holdings that dates back to 1962. Although the survey has not been updated, the breakdown of asset holdings by sector and income class may well have changed. Second, the main assumption underlying Kormendi/Nagle's revenue estimates is that new issues of tax-exempt bonds and existing issues of equities and fully-taxed bonds that these new issues displace are absorbed by investors in the same proportion as their initial holdings of these assets. Financial research carried out over many years has established, however, that it is unlikely that new or displaced assets will be reabsorbed in precisely this proportionate pattern. In fact, the pattern is much more complicated. It depends on investors' preferences, on the variation among different assets' returns, and on how yields on the different assets change in response to the initial increase in the supply of tax-exempt bonds. Taking account of these various factors requires a detailed computer analysis of data on previous patterns of asset holding, rather than the simpler approach taken by Kormendi and Nagle. CBO plans to undertake such an analysis within the next few months. The results might differ significantly from those assumed by Kormendi/Nagle, and the revenue effects might differ correspondingly.

EFFICIENCY OF TAX-EXEMPT BONDS

Whenever tax-exempt bonds are used to provide financing for a project, the benefits are shared primarily between borrower and lender. The sharing reduces the amount of subsidy available to the borrower. The borrower, which may be a public or a private entity, obtains funds at a below-market interest rate. The lender, who is the purchaser of tax-exempt bonds, benefits from making an investment that has a higher after-tax return than an alternative taxable bond. In addition, intermediaries, such as bond counsel and issuers, receive fees that further reduce the amount of subsidy available to the borrower. The so-called "efficiency" of tax-exempt bonds is measured by the amount of subsidy that goes to the borrower. A large share of the federal subsidy is diverted to the lenders, the investors in tax-exempt bonds. The reason is that most tax-exempt bondholders are in marginal tax brackets of from 40 percent to 50 percent, but the interest rates on new issues of tax-exempt bonds must be high enough to attract investors with marginal tax rates as low as 20 percent to 30 percent. The high-bracket investors thus receive a "windfall," that is, a return higher than is actually needed to induce them to buy the bonds. A number of studies have attempted to measure the basic inefficiency resulting from the portion of the subsidy that goes to the investors in tax-exempt bonds. The estimates range from 25 percent to 33 percent. In other words, tax-exempt bonds, as a subsidy mechanism, have a basic efficiency that ranges from 67 percent to 75 percent. This basic efficiency may be reduced by issuer and bond counsel fees and by the amount of the bond issue proceeds that may be set aside for reserve funds. In the case of mortgage bonds, a portion of the proceeds of an issue is generally set aside in a reserve fund. Estimates of the amount of bond proceeds available for mortgages vary from 87 percent, which was reported by the GAO, to 93 percent, which is the number used by the Council on State Housing Agencies. (A CBO sample of 68 issues indicated that total available funds for mortgages averaged 85 percent of bond proceeds for state agencies and 90 percent for local agencies.) The remainder is set aside to provide a reserve fund and to cover issuing fees. These set-asides—whether they amount to 7 percent or 13 percent—further reduce the efficiency of mortgage bonds. If a 10 percent set-aside is combined with a 30 percent diversion to investors and a 3 percent diversion to fees for intermediaries, the efficiency of the subsidy mechanism is reduced to 57 percent; that is, only 57 percent of the federal subsidy is actually being made available to homebuyers by the issuing municipality.

I hope this information addresses your concerns. If we can be of further assistance, please let us know.

With best wishes,

Sincerely,

ALICE M. RIVLIN, *Director.*

Mr. GIBBONS. Mr. Downey, other members want time and your time has expired. Pardon me.

Mr. Pease.

Mr. PEASE. Mr. Chairman, I know we are short on time and I will not ask a question, but in the event that this does happen to be Dr. Rivlin's last appearance before the committee, I would want also to commend her for her superb service to the Congress and the Government and wish her well in her private endeavors.

Ms. RIVLIN. Thank you very much, Mr. Pease.

Mr. GIBBONS. Other members?

Mr. CONABLE. Let me piggyback on that comment also. Dr. Rivlin, you have been an independent and clear voice, and we are grateful for your service. I think every administration with which you have served has resented your second-guessing them. You have been right in many cases where they have not, and I think therefore your services have been extremely valuable to the Congress, which needs to hear divergent voices.

Everybody marches to the same drummer around here too much, and your expertise has been extremely valuable to us. I just wanted to compliment you on the work you have put into your job. You have pretty much defined it yourself, and you have defined it in a constructive way.

Thank you.

Ms. RIVLIN. Thank you, Mr. Conable.

Mr. GIBBONS. Mr. Frenzel.

Mr. FRENZEL. During the Senate Finance Committee hearing on S. 137, which is identical to Mr. Downey's and my bill in the House, I understand that you reponded to the question of whether mortgage subsidy bonds do serve low and moderate income. And if your opinion is the same, I will not ask you to repeat it, but simply ask unanimous consent that we may enter that testimony in this record.

Ms. **Rivlin**. I would be delighted if you wanted to do that, and it does provide more information than this testimony on mortgage subsidy bonds.

Mr. **Frenzel**. I would make that request, Mr. Chairman.

Mr. **Gibbons**. All right. Without objection, so ordered.

[The material referred to follows:]

Senator **Mitchell**. Thank you, Senator.

Dr. Rivlin, before you came in we had some lengthy colloquy trying to find out what people mean when they use certain phrases. In your testimony you used the phrase "middle income home buyers", "upper income home buyers", "upper-middle income home buyer", and now, in oral testimony, you have used the phrase "low income home buyers" and "moderate income home buyers."

Would you tell up, please, what do you mean by any or all of these phrases? What do you understand them to mean?

Ms. **Rivlin**. By "low" and "moderate" I mean in and around and below the median. We can give you more specific in any particular instance, but I think the easiest definitions have to do with where you stand in relationship to the median income.

Senator **Mitchell**. Well, in, around, and below the median? Could I take that to mean that if someone is at or below the median you would regard them as being low or moderate income depending upon how far they are from the median?

Ms. **Rivlin**. Well, I think it depends on the context, but the GAO report found that slightly less than half of the people involved in this program were below the median for their area. I would call that approximately half of the funds are going to low and moderate income families.

Senator **Mitchell**. Well, you see, what emerged was the GAO report concludes that the program has not been successful in preventing upper income families from receiving benefits. It turned out in the discussion, at least at the outset of the discussion, the definition of "upper income" and "affluent" included households with incomes of between $20,000 and $30,000 a year, and I think that the phrases "moderate", "middle", "upper middle", and "upper" mean different things to different people.

Ms. **Rivlin**. They also mean different things in different areas, so I think it is important to know which area you are talking about.

On the higher end, the GAO found that around a third of the recipients had incomes that were more than 120 percent of the median for their area. That does not make them terribly affluent, but it puts them at the higher end.

Senator **Mitchell**. Would you regard a person or a family that has an income of $20,000 a year as affluent or upper income anywhere in the United States?

Ms. **Rivlin**. Of $20,000?

Senator **Mitchell**. $20,000 a year. Would you describe or would you consider it an accurate description to say that a family anywhere in the United States who has an income of $20,000 a year can be described as affluent or upper income?

Ms. **Rivlin**. Probably not, but I would like to know, before I get pinned down, as to whether they live in a rural county in Maine or whether they live in Manhattan. I think that makes a difference.

Senator **Mitchell**. I said anywhere in the United States. Take the most rural county in Maine. Would you regard a family with an income of $20,000 a year as affluent?

Ms. **Rivlin**. Probably not affluent, but you certainly know of counties in which that is not a bad income.

Senator **Mitchell**. It is an inaccurate way to describe—it costs a lot to live in a rural county in Maine. Food costs as much, if not more, than in the urban centers.

Ms. **Rivlin**. Senator, I have not used the word "affluent" and I do not know exactly what we are arguing about.

Senator **Mitchell**. I do not think we are arguing. We have had these phrases bandied about, and all of these statements use—you used five different ones here and I am trying to pin it down so that we can understand what we are talking about.

This program helps—I am for this program. I am biased at the outset, and it helps people who I think are not affluent or not upper income, who need help and who cannot buy homes without it, as people who make $20,000, $25,000, $26,000, $27,000 a year, and by any standard definition of the phrase in this country, by the common accepted American usage the average—not only average but almost every American in the street, they are not affluent Americans.

That is the only point I am trying to make.

Ms. RIVLIN. Right, and the Congress can set limits where it wants to. My only point is that it is useful to look at the relationship to the median income in the area, and you can set it at the median or you can set it at 120 percent of the median, whatever seems to you to be sensible.

STATEMENT BY ALICE M. RIVLIN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE, BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT, COMMITTEE ON FINANCE, UNITED STATES SENATE, MAY 13, 1983

Mr. Chairman, the congress is faced this year with a decision on whether to continue to let tax-exempt state and local bonds be used to finance single-family homes, or to allow this authority to expire on December 31, 1983, as it is now scheduled to do. The revenue consequences of this decision are significant. Single-family mortgage revenue bonds are projected to cost $7.9 billion if the expiration or "sunset" provision does not take effect.

My testimony this morning will cover three areas:

Conditions that led up to the Mortgage Subsidy bond Tax Act of 1980;

Experience since the 1980 act; and

Policy alternatives that the Congress might wish to consider.

CBO has prepared for the record a more detailed paper on recent trends in mortgage revenue bond financing. This statement will briefly summarize the main points of that report.

BACKGROUND

In the early 1970s, state housing agencies began tax-exempt bonds for owner-occupied housing in significant increasing quantities. Local governments and housing agencies first issued tax-exempt bonds for single-family housing in 1978. Because the interest paid on these bonds is tax-exempt, the federal government gives up revenue to subsidize home purchases. State and local governments issue bonds at relatively low tax-exempt rates and relend the proceeds at slightly higher rates for mortgages, making below-market mortgage rates available to many homebuyers.

In response to a surge in bond issues for owner-occupied housing and associated revenue losses, the Congress passed the Mortgage Subsidy Bond Tax Act of 1980. This legislation sharply restricted the use of these bonds in order to reduce revenue losses and to target assistance more effectively. The act contained a sunset provision that ends the use of bonds for single-family homes after 1983. In the meantime, the act set state bond volume limits and home purchase price limits, introduced targeted area requirements, and restricted the subsidy principally to first-time buyers. The Tax Equity and Fiscal Responsibility Act of 1982 eased some of the restrictions in the 1980 act relating to the first-time homebuyer rule, purchase price limits, and arbitrage limitations.

EXPERIENCE SINCE THE 1980 ACT

The volume of single-family housing bonds dropped sharply in 1981 after limits were imposed in 1980, but then grew again in 1982, reaching a level about equal to th 1980 volume. These fluctuations were a response to interest rates and housing market conditions as well as to the provisions of the 1980 and 1982 acts.

THE VOLUME OF MORTGAGE REVENUE BONDS

After a sharp rise in the issuance of housing bonds from $1.4 billion in 1975 to $14.0 billion in 1980, total housing bond volume dropped precipitously to $4.8 billion in 1981. The drop in volume was largely the result of the federal restrictions enacted in December 1980 and the high market interest rates prevailing during the year. After the market conditions improved during the summer of 1982, many jurisdictions were able to issue bonds more easily. In 1982, tax-exempt bonds for housing finance totaled $14.4 billion—$8.8 billion for single-family housing, $5.1 billion for multi-family rental housing, and $0.5 billion for veterans' housing (see Table 1). In that year, housing bonds accounted for 17 percent of all new long-term tax-exempt issues; bonds for owner-occupied housing alone accounted for 10 percent.

Mortgage bond interest rates declined steadily through most of 1982, along with rates for tax-exempt bonds generally. At the same time, the relative advantage of tax-exempt financing diminished. This can be explained partly by the recent tax rate cuts that have reduced individual demand for tax-exempt bonds and by the marked increase in the volume of all tax-exempt issues, including industrial development bonds. In 1982, tax-exempt interest rates were approximately 20 percent lower than comparable taxable rates, down from a 30 percent differential during the previous ten years. Although the spread between taxable and tax-exempt rates has narrowed, lower interest rates in general have brought many potential homebuyers back into the market. Thus, if the sunset date for mortgage revenue bonds is repealed, the volume of issues is likely to rise steadily over the next several years.

TABLE 1.—VOLUME OF TAX-EXEMPT HOUSING BONDS, 1975–82

Year	Total volume tax-exempt bonds	Total housing bonds	Total State revenue bonds		Total local revenue bonds		Total veterans' general obligation bonds
			Single family	Multifamily	Single family	Multifamily[1]	
In millions of dollars:							
1975	30,090	1,436		869		2	565
1976	34,962	2,741	680	1,420		21	620
1977	46,766	4,398	959	2,633		241	584
1978	48,979	6,946	2,792	1,748	619	735	1,155
1979	47,991	12,072	3,333	1,929	4,491	729	1,590
1980	54,086	14,048	4,974	1,379	5,524	839	1,332
1981	56,548	4,834	1,662	711	1,186	405	870
1982	86,351	14,432	5,212	2,784	3,571	2,360	480
Percent of total volume of tax-exempt bonds:							
1975	100	5		3			2
1976	100	8	2	4			2
1977	100	9	2	6		1	1
1978	100	14	6	4	1	2	2
1979	100	25	7	4	9	2	3
1980	100	26	9	3	10	2	2
1981	100	9	3	1	2	1	2
1982	100	17	6	3	4	3	1
Percent of total volume of housing bonds:							
1975	N/A	100		61			39
1976	N/A	100	25	52		1	23
1977	N/A	100	22	60		5	13
1978	N/A	100	40	25	9	11	17
1979	N/A	100	28	16	37	6	13
1980	N/A	100	35	10	39	6	9
1981	N/A	100	34	15	25	8	18
1982	N/A	100	36	19	25	16	3

[1] Includes bonds issued for permanent financing under Section 11(b), bonds for urban redevelopment housing projects, and other local issues for multifamily, rental housing issued under Sections 103A and 103b(4)(A).

Note: 1982 figures are preliminary.

Sources: Total tax-exempt bond volume figures calculated by The Bond Buyer and the Congressional Budget Office. Housing bond volume figures calculated by the Office of Financial Management, Department of Housing and Urban Development, and the Congressional Budget Office.

TARGETING UNDER THE 1980 ACT

The Mortgage Subsidy Bond Tax Act of 1980 targeted mortgage assistance by:

Focusing aid on low-income areas and areas of chronic economic distress;

Imposing home purchase-price limits; and

Making assistance available only to first-time homebuyers, except in targeted areas.

Experience under these provisions has varied widely. Some housing agencies and local governments have targeted their programs as much as possible on economically distressed areas and low-income homebuyers (and might have done so without federal requirements), while others have sought to minimize the impact of the act's targeting provisions in order to improve the financial backing behind the bonds and to reassure bondholders. Since the 1980 act was passed, new legislation and regulatory changes have eased the targeting provisions of the act.

Targeted areas.—The 1980 act required that a specified portion of bond proceeds be lent to people buying homes in targeted areas. (The amount may be either 20 percent of an issue's lendable proceeds or 40 percent of average annual home mortgages within targeted areas in the issuer's jurisdiction, whichever is less.) The act defined targeted areas as those census tracts where 70 percent of families have incomes of not more than 80 percent of statewide median income, or areas of chronic economic distress if so approved by the Secretaries of the Treasury and the Department of Housing and Urban Development.

When the 1980 act was passed, most states contained census tracts that qualified automatically as targeted areas. Since July 1981, however, 38 states have also had specific economically distressed areas approved as targeted areas. Applications propose areas as small as city neighborhoods and as large as two-thirds of a state. A Treasury Department regulation limiting targeted areas to 20 percent of a state's population was in place until May 1982. Since then, the total population living in targeted areas has risen well above 20 percent in several states, reaching as high as 50 percent in a few states.

States and localities issuing bonds often seek to minimize the burden of the targeted-area requirements by allocating as few bond funds to targeted areas as is allowable. The majority of issuers make their allotments to targeted areas on the basis of the market-share rule, thereby enabling them to set aside less than 20 percent of their mortgage funds for targeted areas. Issuers are able to set aside much less than 20 percent of their mortgage funds when the targeted areas in their jurisdiction are very small, when there have been very few recent home sales in targeted areas, or when the sales prices of homes located in targeted areas have been quite low.

Purchase price limits.—The 1980 act limited the use of bonds to the financing of houses costing no more than 90 percent of the average area purchase price for a home not located in a targeted area and to 110 percent of the average area purchase price for a home located within a targeted area. TEFRA eased these limits by raising them to 110 and 120 percent, respectively.

Average home prices vary greatly from state to state and even from city to city, and thus purchase price limits vary as well. The Internal Revenue Service (IRS) published a listing of average area purchase prices that implied purchase price limits in 1982 ranging from about $49,000 to about $167,000 for new homes not located in targeted areas and from about $37,000 to about $158,000 for existing homes, assuming the homes were financed by bonds issued after TEFRA's enactment. The price limits in targeted areas were almost 10 percent higher.

Although most issuers in 1982 used the estimates of average area purchase prices provided by the IRS to calculate their purchase price limits, a few state and local issuers chose to set higher purchase price limits, based on their own estimates of average area purchase prices. For example, Alaska's Housing Finance Corporation set a purchase price limit of $128,000 for new houses when the limit calculated according to IRS data would have been $111,000. On the other side, several other issuers set some or all of their purchase price limits below those allowable under the 1980 act.

As can be seen, limits based on average area purchase price allocate federal assistance very unevenly, with more affluent areas receiving a larger share of the federal subsidy. This effect is often exggerated when issuers use their own estimates of their area's average purchase price. The effectiveness of purchase price limits in targeting assistance toward lower income areas also varies greatly among states and localities because of differences in program design. In any event, most purchase price limits indirectly target aid by income because they discourage many middle- and upper-income homebuyers from seeking bond-subsidized mortgages.

Income limits.—In addition, most states and localities impose explicit income limits on homebuyers, although such limits are not federally required. A sample of 40 state issues in 1982 shows income limits ranging from between $16,000 and $36,000 in Indiana to between $26,000 and $60,000 in Arizona. In a sample of 28 local issues, income limits spanned a narrower range, from $26,000 in San Francisco to $60,000 in Tucson, Arizona. Three states and several localities imposed no income limits at all. The use of income limits obviously varies widely, making only upper- and upper-middle income homebuyers ineligible in many cases.

OPTIONS

As the sunset date for single-family mortgage revenue bonds approaches, the Congress must choose whether to let this authority terminate, extend it in its current form, or extend it in some altered form. If current law remains in effect, the authority for single-family mortgage bonds will expire at the end of the year. At that time, $39.4 billion in bonds will still be outstanding. The revenue losses associated with these bonds will total $1.5 billion in 1983 and will rise to $1.7 billion in fiscal year 1984. Subsequently, the revenue loss will level off and begin to decline gradually. Total esimated revenue losses for fiscal years 1984 to 1988 amount to $7.9 billion.

If, on the other hand, the sunset date is repealed, revenue losses over the 1984 to 1988 period are estimated at $10.7 billion. The difference of approximately $2.8 billion understates the revenue effects of the continued use of the bonds, however. Every time a state or local government issues a mortgage revenue bond (or, for that matter, any tax-exempt bond), the federal government sustains revenue losses for as long as the debt is outstanding. Most mortgage bonds have staggered or serial maturities for up to 30 years. Ten years after a bond is issued, more than 80 percent of the issue will still be outstanding. Accordingly, a more appropriate way to look at the cost of mortgage revenue bonds is to calculate the amount of subsidy commitment over the life of the bonds.

To illustrate this point, although the additional revenue loss of not repealing mortgage revenue bonds would amount to an estimated $2.8 billion over the next five fiscal years, during the same period the federal government would commit itself to $24.1 billion in net new subsides for single-family homes (see Table 2). The present value of the commitment would be $11.8 billion. (The present value of the commitment is the multiyear stream of revenue losses, discounted for the fact that losses in the later years have a lower current cost than those in the early years.) Although mortgage revenue bonds involve a multiyear commitment, the long-term costs of new issues do not appear in budget documents. The full costs of most direct housing assistance programs, however, now appear in the budget, with an amount of budget authority expected to pay the full 15- to 30-year expense set aside at the time that new commitments are made.

TABLE 2.—NET NEW SINGLE-FAMILY MORTGAGE BOND REVENUE LOSSES FROM REPEAL OF THE SUNSET PROVISION, 1984 to 1988

[In billions of dollars, by calendar year except as noted]

	1984	1985	1986	1987	1988	Total [1]
Estimated bond issues	10.4	13.0	16.9	20.4	23.6	84.3
Federal subsidy over the term of the bonds	3.5	4.2	5.0	5.4	5.9	24.1
Present value of the subsidy commitment	1.7	2.1	2.6	2.6	2.9	11.8
Fiscal year revenue losses	0.1	0.2	0.5	0.8	1.2	2.8

[1] Totals may not add because of rounding.

Regardless of how costs are budgeted, tax-exempt bonds are generally less efficient than direct subsidies—that is, a smaller proportion of federal expenditure is realized in subsidy by the homebuyers. A CBO analysis undertaken a few years ago indicated that, in the case of tax-exempt mortgage bonds, approximately 54 percent of the subsidy went to the homebuyers. Most of the remainder went to bondholders and intermediaries, including issuers, underwriters, and bond counsel. A small portion of the subsidy represented an offset for the lower mortgage interest deductions of program recipients. In contrast, the Section 235 direct mortgage assistance program was 90 percent cost-efficient. Apart from direct subsidy programs, more efficient means of assisting homebuyers may be available within the tax system, such as direct tax credits for homebuyers.

If the use of the bonds is continued, the Congress could target the subsidy more narrowly on low- and moderate-income households by placing federal income limits on homebuyers or by limiting the subsidy to homebuyers who forgo the deduction of mortgage interest from taxable income. Although income limits would concentrate the subsidy on those homebuyers most in need of financial aid, they would probably not reduce the volume of mortgage revenue bonds significantly unless they were very low. Requiring a choice between interest deductions and the bond subsidy could have a greater effect on volume as would more stringent state-by-state caps on volume. Income ceilings would involve administrative problems of monitoring compliance and making adjustments for regional cost-of-living variations. Limiting the subsidy to homebuyers who forgo the deduction of mortgage interest would be an administratively simpler way to target assistance to lower-income households. Taxpayers in higher marginal brackets would be better off taking the interest deduction and would automatically exclude themselves from the program. Lower-income homeowners benefit little or not at all from mortgage interest deductions and so would prefer the bond subsidy.

Finally, if the Congress decides not to repeal the sunset provision in the Mortgage Subsidy Bond Tax Act of 1980, it may wish to consider new restrictions on the uses of tax-exempt bonds for private and quasi-public purposes in order to keep deficits from climbing higher. At present, mortgage bonds are subject to state-by-state volume limits. The Congress may wish to consider similar limits for tax-exempt bonds that finance industrial development, pollution control, private hospitals, port and airport facilities, trade show and convention centers, and other privately owned facilities. It may also want to reconsider the restrictions that the Administration and the Senate Finance Committee proposed last year, which would have required that private investment financed with tax-exempt bonds be depreciated over longer recovery periods than those permitted under current law.

MORTGAGE REVENUE BONDS IN 1982, SPECIAL STUDY PREPARED AT THE REQUEST OF SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT, COMMITTEE ON FINANCE, U.S. SENATE, MAY 1983

This study was prepared by Martha Smith and Pearl Richardson of the Tax Analysis Division of the Congressional Budget Office, under the supervision of James M. Verdier. Questions regarding the analysis may be addressed to them at 226-2680.

MORTGAGE REVENUE BONDS IN 1982

The tax-exempt status of newly issued, single-family mortgage revenue bonds is scheduled to "sunset," or expire, on December 31, 1983. Despite federal restrictions on the use of housing bonds enacted in 1980 and the difficulties of a recessionary marketplace, housing bonds have continued to be a popular vehicle for state and local governments that aim to assist homebuyers and the housing industry. This report provides information about the issuance of mortgage revenue bonds in 1982, as background to the current debate on the sunset provision.

LEGISLATIVE HISTORY

Although the first tax-exempt housing bonds were issued just after World War I, state housing agencies did not begin to issue tax-exempt bonds for rental and owner-occupied housing in any great quantity until the early 1970s. Local governments and housing agencies first issued tax-exempt bonds for single-family housing in 1978. Because the interest paid on these bonds is tax-exempt, the federal government gives up revenue to subsidize home purchases. (See Section 103A and Section 103b(4)(A) of the Internal Revenue Code.) State and local governments issue bonds at relatively low tax-exempt rates and relend the proceeds at slightly higher rates for mortgages. Below-market mortgage rates are thus made available to many homebuyers.[1]

In response to a surge in the issuance of these bonds, the Mortgage Subsidy Bond Tax Act of 1980 (MSBTA) sharply restricted the use of tax-exempt bonds for housing in an attempt to reduce revenue losses and to target assistance more effectively. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) eased slightly some of the restrictions in MSBTA for single-family bonds relating to the first-time homebuyer rule, purchase price requirements, and arbitrage limitations. Also, the income requirements for Section 103b(4)(A) bonds for rental housing were clarified. TEFRA did not modify prior law relating to state bond volume limits, requirements for funds in targeted areas, the registration requirement, or the rules specific to veterans' housing, rental housing, and home improvement loans.[2]

VOLUME OF MORTGAGE REVENUE BONDS, 1975–1982

Tax-exempt bond issues for housing finance totaled about $1.4 billion in 1975, $6.9 billion in 1978, and $14.0 billion in 1980. Starting in 1978, much of the growth in volume resulted from local governments and local housing agencies entering the tax-exempt housing bond market. After the sharp rise in the issuance of housing bonds in 1975–1980, the volume dropped precipitously to about $4.8 billion in 1981, largely because of the restrictive legislation passed in December 1980 and the high market interest rates prevailing during the year. During 1982, however, mortgage interest rates fell, making more would-be homebuyers able to afford mortgages. As a result, the 1980 volume level was regained and surpassed. Preliminary estimates put the total for 1982 at about $14.4 billion, with single-family housing accounting for about $8.8 billion of that amount (see Table 1).[3]

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[1] See Congressional Budget Office, The Mortgage Subsidy Bond Tax Act of 1980: Experience Under the Permanent Rules (March 1982); and Congressional Budget Office, Tax-Exempt Bonds for Single-Family Housing (April 1979).

[2] See Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982 (Dec. 31, 1982), pp. 116 and 120–23.

In 1980, states and state agencies issued $5 billion in owner-occupied (single-family) housing bonds; they issued only $1.7 billion in 1981 and then came back with $5.2 billion in 1982. Local issues for owner-occupied housing totaled $5.5 billion in 1980, $1.2 billion in 1981, and $3.6 billion in 1982. Bonds issued under Sections 103A and 103b(4)(A) for multifamily, rental housing totaled $4.3 billion in 1982, with about $2.7 billion issued by states and about $1.6 billion issued by localities. General obligation bonds issued by states for veterans' single-family housing totaled about $0.5 billion in 1982. These issues, however, are not subject to most of the restrictions enacted in MSBTA.

Housing bonds accounted for 17 percent of all new long-term tax-exempt issues in 1982. Bonds for single-family houses alone accounted for 10 percent. Mortgage bond interest rates declined steadily throughout 1982, along with rates for tax-exempt bonds generally. In January 1982, the Bond Buyer index for tax-exempt revenue bonds stood at 14.2 percent; by December, it had declined to 10.7 percent. Although interest rates were lower in absolute terms, the relative advantage of tax-exempt financing diminished in 1982 for several reasons, including a marked increase in the volume of all tax-exempt issues and the recent tax rate cuts that have reduced individual demand for tax-exempt bonds. In 1982, tax-exempt interest rates were approximately 20 percent lower than comparable taxable rates. During the previous ten years, by contrast, tax-exempt interest rates were on average about 30 percent lower than comparable taxable rates.

TABLE 1.—VOLUME OF TAX-EXEMPT HOUSING BONDS, 1975–82

Year	Total volume tax-exempt bonds	Total housing bonds	Total State revenue bonds		Total local revenue bonds		Total veterans' general obligation bond
			Single family	Multifamily	Single family	Multifamily [1]	
In millions of dollars							
1975	30,090	1,436	...	869	...	2	565
1976	34,962	2,741	680	1,420	...	21	620
1977	46,766	4,398	959	2,633	...	241	584
1978	48,979	6,946	2,792	1,748	619	735	1,155
1979	47,991	12,072	3,333	1,929	4,491	729	1,590
1980	54,086	14,048	4,974	1,379	5,524	839	1,332
1981	56,548	4,834	1,662	711	1,186	405	870
1982	86,351	14,432	5,212	2,784	3,571	2,360	480
Percent of total volume of tax-exempt bonds							
1975	100	5	...	3	...	...	2
1976	100	8	2	4	...	...	2
1977	100	9	2	6	...	1	1
1978	100	14	6	4	1	2	2
1979	100	25	7	4	9	2	3
1980	100	26	9	3	10	2	2
1981	100	9	3	1	2	1	2
1992	100	17	6	3	4	3	1
Percent of total volume of housing bonds							
1975	N/A	100	...	61	...	...	39
1976	N/A	100	25	52	...	1	23
1977	N/A	100	22	60	...	5	13
1978	N/A	100	40	25	9	11	17
1979	N/A	100	28	16	37	6	13
1980	N/A	100	35	10	39	6	9

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[3] All figures in this section are from the Office of Financial Management, Department of Housing and Urban Development. The 1982 figures are preliminary. The types of housing bonds included in the overall totals are single-family, multifamily, home-improvement, and veterans' general obligation bonds issued under Sections 103A and 103b(4)(A), and multifamily bonds for rental housing issued under Section 11b.

TABLE 1.—VOLUME OF TAX-EXEMPT HOUSING BONDS, 1975–82—Continued

Year	Total volume tax-exempt bonds	Total housing bonds	Total State revenue bonds		Total local revenue bonds		Total veterans' general obligation bond
			Single family	Multifamily	Single family	Multifamily [1]	
1981	N/A	100	34	15	25	8	18
1982	N/A	100	36	19	25	16	3

[1] Includes bonds issued for permanent financing under Section 11(b), bonds for urban redevelopment housing projects, and other local issues for multifamily, rental housing issued under Sections 103A and 103b(4)(A).

Note: 1982 figures are preliminary.

Sources: Total tax-exempt bond volume figures calculated by The Bond Buyer and the Congressional Budget Office. Housing bond volume figures calculated by the Office of Financial Management, Department of Housing and Urban Development, and the Congressional Budget Office.

HOUSING MARKET CONDITIONS IN 1981 AND 1982

State and local issuers were able to sell very few housing bonds in 1981. Difficult market conditions and new federal requirements aimed at increasing targeting and efficiency caught them in a bind; at the same time that home mortages—even when subsidized by tax-exempt financing—were becoming increasingly unaffordable for many homebuyers, the 1980 legislation reduced the pool of homebuyers eligible to receive tax-exempt financing on mortgage loans.

Mortgage interest rates (recorded at the time of closing) peaked at about 16 percent in the fall of 1981 and have drifted down to between 12 and 13 percent since then. The high mortgage rates prevalent in 1981 and much of 1982 made mortgages financed with tax-exempt bonds highly attractive because of the large differential between market and subsidized rates. Many programs were able to offer 14 percent mortgage loans when the commercial mortgage rate in their region was as high as 16 or 17 percent. (Of course, many potential homebuyers could not afford even the subsidized mortgages.) As commercial mortgage rates declined, however, the differential between market and subsidized rates narrowed because tax-exempt bond yields did not drop as much or as fast as mortgage rates. As mortgage rates fell during the summer of 1982, many issuers were forced to redeem bonds because they could find even fewer home purchasers interested in the mortgages they were offering than earlier in the year. The lower rates in late 1982 brought many potential homebuyers back into the housing market, thus increasing the demand for bond-financed as well as conventionally financed mortgages.

As a result of high mortgage rates combined with a recessionary economy, housing starts in both 1981 and 1982 were the lowest they had been in the postwar period. Sales of new houses fell in 1982 to the lowest level since 1963 when such statistics were first collected. Sales of previously occupied houses fell to the lowest level since 1970.[4] The decline in mortgage rates toward the end of 1982 has stimulated the housing market, however, and the National Association of Homebuilders predicts that about 580,000 new one-family homes will be sold in 1983, well over the 545,000 total for 1980.[5]

IMPORTANT TRENDS IN BOND FINANCING IN 1982

Original-issue deep-discount bonds.—In response to high and unpredictable mortgage rates, several state and local issuers of mortgage revenue bonds chose to issue deep-discount bonds as an alternative to conventional current coupon bonds. At least 20 state issue (both single-family and multifamily) and at least three local issues used discount bonds. Discount bonds work by offering coupon payments well below the market rate of return (some, in fact, offer no coupon payments at all). The issuer, therefore, must sell these bonds at a substantial discount from par in order to make them competitive in the marketplace. Bondholders earn both coupon payments and the appreciation from the discounted price to par value as their bonds mature. The advantage discount bonds have for the issuer is that they decrease required coupon payments to bondholders, thus easing cash flow problems in the early months of an issue when all the intended mortgage loans have not yet been made.

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[4] James L. Freund, "The Housing Market, Recent Developments and Underlying Trends," Federal Reserve Bulletin (February 1983), pp. 61–63.

[5] Telephone conversation with William Young, Economics Division, National Association of Home Builders (Apr. 14, 1983).

FSLIC and FDIC certificates of deposit.—At least 24 local multifamily bonds issued under Section 103b(4)(A) in 1982 were backed by certificates of desposit from federally insured financial institutions. These bonds are effectively backed by a federal guarantee. Because the certificates of deposit are pledged to secure repayment of these bonds, the Federal Savings and Loan Insurance Corporation (FSLIC) and the Federal Deposit Insurance Corporation (FDIC) guarantee repayment up to $100,000 per bondholder.

The Department of the Treasury announced on March 4, 1983, that it was drafting legislation to ban the issuance of such bonds after April 15, 1983 (unless a binding commitment had been made before the Treasury announcement). This legislation (S. 1061) has been introduced by Senator Robert Dole. Also, Representative J. J. Pickle has introduced a bill (H.R. 1635) that would deny tax exemption after April 14, 1983, for bonds backed by FSLIC and FDIC insurance. This method of providing added security for multifamily, loans-to-lenders mortgage revenue bonds was important in 1982 and early 1983. It has probably been discontinued since April 15, however, because bond counsel are not likely to approve FSLIC- or FDIC-guaranteed bonds sold after April 15 while the legislation in pending.

1982 SINGLE-FAMILY HOUSING BOND ISSUES IN DETAIL

The following sections describe a sample of 1982 single-family mortgage revenue bond issues. The sample includes 40 of the 65 state single-family issues sold in 1982 and 28 of the 119 local single-family issues. Tables 2 and 3 provide specific information for each issue studied.

Summary.—Experience with the targeted area requirements has shown highly variable results; some issuers target their programs as much as possible on low-income areas (and might do so without federal requirements), while other seek to minimize targeted-area financing in order to improve the financial backing behind the bonds and reassure bondholders. Purchase price limits have a fairly strong general targeting effect because they discourage many middle- and upper-income homebuyers from seeking these subsidized mortgages. Most issuers also impose income limits on homebuyers to target the loan assistance, even though income limits are not federally required. These limits vary widely, however, making only upper- and upper-middle income homebuyers ineligible in many cases.

TABLE 2. STATE HOUSING AGENCIES: SAMPLE OF BONDS ISSUED IN 1982 FOR OWNER-OCCUPIED HOUSING

Issue	Date of Sale	Bond Amount (millions of dollars)	Net Interest Cost (percents)	Type of Obligation of the Issuer[a]	Mortgage Rate (percents)[b]
Alabama HFA 1982 Series B	12/9/82	100.000	10.76	LO	11.270
Alaska HFC 1982 Second Series	11/24/82	100.000	11.54	GO	10.000
Arizona HFRB Series 1982	11/8/82	27.200	9.92	LO	11.050
Arkansas HDA 1982 Series A	7/27/82	100.000	13.13	SO	12.950
California HFA 1982 Series B	12/17/82	101.775	10.50	SO	mixed
Colorado HFA 1982 Series A	7/29/82	66.050	12.78	SO	12.750
Connecticut HFA 1982 Series B	9/10/82	150.000	11.06	GO	11.750
Delaware SHA 1982 Series A	6/24/82	40.000	13.33	SO	13.750
Florida HFA 1982 Series A	6/15/82	150.000	13.50	N/A	13.500
Georgia RFA 1982 Series A	9/17/82	50.000	10.70	GO	11.875
Hawaii HA 1982 Series A	7/16/82	60.000	13.00	SO	13.250
Illinois HDA 1982 Series A	7/30/82	90.000	11.85	GO	12.950
Indiana HFA 1982 Series A	4/6/82	75.000	N/A	SO	13.780
Iowa HFA 1982 Issue A	9/3/82	14.080	11.70	GO	12.525
Louisiana HFA Series 1982A	8/23/82	100.000	12.60	SO	13.250
Maine SHA 1982 Series B	6/10/82	53.920	12.92	SO	13.250
Maryland CDA 1982 Series A	3/19/82	65.000	13.27	SO	13.900
Massachusetts HFA 1982 Series A	8/10/82	200.000	13.57	SO	13.700
Minnesota HFF 1982 Series B	8/12/82	41.900	11.57	GO	15.250
Mississippi HFC Series 1982	8/20/82	150.500	11.26	GO	12.250
Missouri HDC Series April 15, 1982	3/31/82	50.000	13.25	N/A	13.870
Montana BH 1982 Series A	4/6/82	55.000	13.50	GO	12.500
Nebraska MFF 1982 Series B	7/21/82	89.410	11.52	GO	13.625
Nevada HD 1982 Issue A	7/14/82	60.000	14.00	SO	12.250
New Hampshire HFA 1982 Series A	7/1/82	167.255	13.06	SO	13.250
New Jersey MFA 1982 Series 1	10/7/82	239.000	10.60	GO	11.000
New Mexico MFA 1982 Series A	9/1/82	98.655	10.54	SO	12.120
New York SMA Series 3	7/8/82	250.000	13.22	GO	14.000
North Dakota HFA 1982 Series A	7/15/82	28.940	12.77	LO	13.500
Oregon, State of, 1982 Series A	9/24/82	125.000	11.19	SO	11.750
Pennsylvania HFA 1982 Series A	4/1/82	100.000	13.73	GO	14.050
Rhode Island HMFC 1982 Series 1	7/23/82	30.850	13.30	SO	13.750
South Carolina SHA 1982 Series A	9/21/82	82.265	N/A	SO	11.950
Tennessee 1982 Series A	7/27/82	150.000	12.75	GO	12.750
Texas HA 1982 Series A	7/9/82	100.000	13.72	LO	14.000
Utah HFA 1982-First Series	5/28/82	121.765	12.68	SO	12.000
Vermont HFA 1982 Series A	7/15/82	35.000	13.45	GO	13.500
Virginia HDA 1982 Series B	11/9/82	166.109	9.42	GO	10.420
West Virginia HDF Series A	3/5/82	25.000	13.85	SO	12.950
Wisconsin HFA 1982 Series A	7/1/82	100.000	13.80	GO	13.750

N/A = information not available.

a. LO = limited obligation
SO = special obligation
GO = general obligation

b. Mortgage interest rates are sometimes lower than the yields on the bonds because of additional funds from fees or contributions from the issuer.

TABLE 2. (Continued)

Issue	Type of Mortgage[c]	Percentage Distribution of Funds Including Contributions and Fees (percents)		Percent of Loan Funds Reserved for Targeted Areas	Applying for New Targeted Areas?[d]
		Mortgages	Other		
Alabama HFA 1982 Series B	Level:30	90	10	20	No*
Alaska HFC 1982 Second Series	GEM:19	99	1	0	No
Arizona HFRB Series 1982	Level:30	92	8	N/A	No*
Arkansas HDA 1982 Series A	GEM:20	92	8	1	Yes*
California HFA 1982 Series B	mixed	96	4	20	Yes*
Colorado HFA 1982 Series A	GEM:17	73	27	N/A	Yes*
Connecticut HFA 1982 Series B	GEM:17	83	17	20	No*
Delaware SHA 1982 Series A	Level:20	93	7	4	No
Florida HFA 1982 Series A	GEM:16	89	11	12	No*
Georgia RFA 1982 Series A	GEM:18	92	8	20	Yes*
Hawaii HA 1982 Series A	GEM:19	86	14	8	No*
Illinois HDA 1982 Series A	GEM:17	79	21	5	No*
Indiana HFA 1982 Series A	Level:25	84	16	20	No*
Iowa HFA 1982 Issue A	Level:30	93	7	0	No
Louisiana HFA Series 1982A	Level:30	92	8	2	Yes*
Maine SHA 1982 Series B	Level:20	85	15	N/A	No
Maryland CDA 1982 Series A	Level:30	93	7	20	Yes*
Massachusetts HFA 1982 Series A	Level:30	91	9	2	No
Minnesota HFF 1982 Series B	Level:30	90	10	4	No*
Mississippi HFC Series 1982	GEM:16	81	19	N/A	Yes*
Missouri HDC Series April 15, 1982	Level:19	91	9	6	No
Montana BH 1982 Series A	Level:25	84	16	1	No*
Nebraska MFF 1982 Series B	Level:30	80	20	0.1	No*
Nevada HD 1982 Issue A	GEM:16	92	8	5	No
New Hampshire HFA 1982 Series A	Level:25 to 30	29	71	20	No*
New Jersey MFA 1982 Series 1	Level:30	91	9	20	No*
New Mexico MFA 1982 Series A	Level:30	74	26	3	No
New York SMA Series 3	Level:30	87	13	20	Yes*
North Dakota HFA 1982 Series A	GEM:20	89	11	0	Yes
Oregon, State of, 1982 Series A	Level:30	74	26	20	No*
Pennsylvania HFA 1982 Series A	Level:30	90	10	20	Yes*
Rhode Island HMFC 1982 Series 1	GEM:17	93	7	N/A	No
South Carolina SHA 1982 Series A	Level:30	95	5	21	No*
Tennessee 1982 Series A	GEM:16	81	19	20	No*
Texas HA 1982 Series A	Level:30	86	14	20	Yes
Utah HFA June 1982	GEM:16	78	22	0.1	No*
Vermont HFA 1982 Series A	Level:25	84	16	0	No*
Virginia HDA 1982 Series B	Level:30	97	3	19	Yes*
West Virginia HDF Series A	GEM:16	88	12	20	Yes*
Wisconsin HFA 1982 Series A	Level:30	91	9	10	No*

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c. Level = level payment mortgage amortized over the specified numbers of years.
GEM = growing equity mortgage paid off at the specified number of years.

d. * = This state has applied for and received designation of at least one targeted area from the Secretaries of the Treasury and of Housing and Urban Development since the regulations for the Mortgage Subsidy Bond Tax Act were published in July 1981. The

TABLE 2. (Continued)

Issue	Purchase Price Limits for a One-Family Residence in a Non Targeted Area		Below, Equal, or Above IRS Safe-Harbor Purchase Price Limits	Number of Lenders	Income Limit for a Household of Four (thousands of dollars)[e]
	New (thousands of dollars)	Existing (thousands of dollars)			
Alabama HFA 1982 Series B	71	62	Equal	39	[illegible]
Alaska HFC 1982 Second Series	128	105	Above	N/A	no limit
Arizona HFRB Series 1982	84	68	Below or Equal	6	26 to 60
Arkansas HDA 1982 Series A	56 to 58	53 to 55	Equal	140	34
California HFA 1982 Series B	52 to 101	---	Below or Equal	24	28 to 50
Colorado HFA 1982 Series A	71 to 72	49 to 63	Equal	N/A	32
Connecticut HFA 1982 Series B	73 to 93	60 to 80	Below or Equal	60	27 to 34
Delaware SHA 1982 Series A	67	52	Equal	24	38
Florida HFA 1982 Series A	50 to 72	35 to 65	Equal	73	31 to 35
Georgia RFA 1982 Series A	65	52 to 53	Below or Equal	67	27 to 38
Hawaii HA 1982 Series A	105 to 113	100 to 102	Equal	24	N/A
Illinois HDA 1982 Series A	66 to 74	39 to 64	Equal	N/A	35
Indiana HFA 1982 Series A	51 to 75	41 to 45	Below or Equal	65	16 to 36
Iowa HFA 1982 Issue A	78	57	Below or Equal	13	25 to 34
Louisiana HFA Series 1982A	69 to 84	51 to 67	Equal or Above	70	40
Maine SHA 1982 Series B	55	50	Below	28	27
Maryland CDA 1982 Series A	---	49 to 60	Below or Equal	24	33
Massachusetts HFA 1982 Series A	58 to 71	46 to 58	Below or Equal	128	28 to 32
Minnesota HFF 1982 Series B	60 to 70	50 to 60	Below	171	26 to 35
Mississippi HFC Series 1982	59	42	Equal	33	39
Missouri HDC Series April 15, 1982	53 to 75	42 to 46	Equal	31	28
Montana BH 1982 Series A	65	56	Below	110	32
Nebraska MFF 1982 Series B	46 to 56	36 to 46	Equal	43	33
Nevada HD 1982 Issue A	75	75	Below	14	34
New Hampshire HFA 1982 Series A	56	49	Equal	51	27 to 40
New Jersey MFA 1982 Series 1	85 to 119	78 to 96	Equal	N/A	no limit
New Mexico MFA 1982 Series A	77	67	Equal	26	33
New York SMA Series 3	59 to 84	38 to 71	Equal	51	no limit
North Dakota HFA 1982 Series A	71	56	Equal	28	33
Oregon, State of, 1982 Series A	60	55	Below	42	25
Pennsylvania HFA 1982 Series A	42 to 69	30 to 52	Equal	74	35 to 37
Rhode Island HMFC 1982 Series 1	65 to 66	46 to 52	Equal	N/A	33
South Carolina SHA 1982 Series A	53	50	Below	49	32
Tennessee 1982 Series A	40 to 52	33 to 49	Below	106	30
Texas HA 1982 Series A	58 to 100	45 to 78	Equal	104	38
Utah HFA June 1982	70 to 83	49	Equal	24	34
Vermont HFA 1982 Series A	53 to 57	43 to 56	Equal or Above	21	33
Virginia HDA 1982 Series B	61 to 86	43 to 80	Below	97	24 to 45
West Virginia HDF Series A	50	46	Equal	23	33
Wisconsin HFA 1982 Series A	63	50	Equal	367	23 to 34

(Continued)

application and/or designation may have occurred, however, after the bond issue listed in this table. For example, Vermont reserved no funds for targeted areas in the issue listed, but has applied for and received designation of a targeted area since then.

[e] When there is a range of income limits within a given state, the limits generally vary according to geographic location or according to whether the mortgagor is buying new or existing housing.

TABLE 3. LOCALITIES AND LOCAL HOUSING AUTHORITIES: SAMPLE OF BONDS ISSUED IN 1982 FOR OWNER-OCCUPIED HOUSING

Issue	Date of Sale	Bond Amount (millions of dollars)	Net Interest Cost[a] (percents)	Type of Obligation of the Issuer[b]
Palm Springs, CA Issue of 1982	3/5/82	19.300	12.83	SO
Denton Co., TX Series 1982	3/11/82	25.850	13.55	LO
Coon Rapids, MN Series 1982	4/27/82	30.000	N/A	SO
Fairbanks North Star, AK Series 1982	4/30/82	35.000	N/A	SO
Cameron Co., HFC, TX 1982 Series A	5/5/82	30.000	N/A	LO
Central California MA, 1982 Series A	5/20/82	30.000	N/A	LO
Bexar Co. HFC, TX Series 1982	5/25/82	69.210	N/A	LO
San Mateo Co., CA 1982 Series A	6/8/82	40.860	13.01	LO
Volusia Co. HFA, FL Series 1982	6/10/82	11.905	N/A	LO
Wichita, KS 1982 Series A	6/23/82	30.000	N/A	LO
Denver City and Co., CO 1982 Series A	6/29/82	26.625	N/A	SLO
Atlanta URFA, GA Series 1982	7/16/82	30.000	N/A	LO
Tucson IDA and Pima Co. IDA, AZ Series 1982	7/19/82	51.875	11.54*	SO
New Castle Co., DE 1982 Series A	7/23/82	50.000	13.31	LO
Broward Co. HFA, FL 1982 Series A	7/29/82	34.300	13.59*	LO
Santa Fe Springs RA, CA 1982 Series A	8/3/82	9.580	12.51	SO
St. Louis, MO Series 1982 A	8/6/82	20.180	12.66	LO
Albuquerque, NM	8/23/82	19.100	11.83	SO
Maricopa Co. IDA and Phoenix IDA, AZ Series 1982	8/27/82	113.000	N/A	LO
Jefferson Co., CO 1982 Series A	9/13/82	19.875	N/A	SLO
Cobb Co. HA, GA Series 1982	10/1/82	10.165	11.04	LO
Prince George's Co. HA, MD 1982 Series A	10/8/82	35.950	N/A	LO
San Francisco, CA 1982 Bonds Series A	10/8/82	60.000	N/A	LO
Allegheny Co. RFA, PA 1982 Series A	11/12/82	25.000	N/A	LO
Montgomery Co. HOC, MD 1982 Series A	12/3/82	37.495	N/A	LO
Cook Co., IL 1982 Series A and Series B	12/8/82	70.000	N/A	LO
Los Angeles Co., CA 1982 Issue B	12/14/82	75.000	N/A	SLO
Northern Kentucky Series 1982	12/21/82	15.750	N/A	LO

N/A = information not available.

a. * = Information provided in GAO preliminary list of single-family issues.

b. SO = special obligation
LO = limited obligation
SLO = special, limited obligation

Table 3. (Continued)

Issue	Mortgage Rate (percents)[c]	Type of Mortgage[d]	Distribution of Funds Including Contributions and Fees		Percent of Loan Funds Reserved for Targeted Areas[e]
			Percent for Mortgages	Percent for Other Uses	
Palm Springs, CA Issue of 1982	13.125	Level:30	93	7	0.0
Denton Co., TX Series 1982	13.55	N/A:20	96	4	N/A
Coon Rapids, MN Series 1982	13.00	Level:30	87	13	N/A
Fairbanks North Star, AK Series 1982	10.00	N/A:N/A	95	5	0.0
Cameron Co., HFC, TX 1982 Series A	13.375	GEM:15	93	7	?
Central California MA, 1982 Series A	12.125	Level:30	84	16	?
Bexar Co. HFC, TX Series 1982	13.125	GEM:15	92	8	?
San Mateo Co., CA 1982 Series A	13.00	Level:30	93	7	0.0
Volusia Co. HFA, FL Series 1982	12.875	GEM:14	94	6	1.1
Wichita, KS 1982 Series A	13.40-13.825	GEM:17	91	9	N/A
Denver City and Co., CO 1982 Series A	12.99	GEM:15	87	13	?
Atlanta URFA, GA Series 1982	13.375	GEM:16	93	7	22.0
Tucson IDA and Pima Co. IDA, AZ Series 1982	12.95	GEM:15	88	12	5.2
New Castle Co., DE 1982 Series A	13.625	Level:25	88	12	5.5
Broward Co. HFA, FL 1982 Series A	12.75	GEM:16	69	31	N/A
Santa Fe Springs RA, CA 1982 Series A	13.05	Level:30	87	13	N/A
St. Louis, MO Series 1982 A	13.00	Level:30	93	7	5.0
Albuquerque, NM	12.35	GEM:15	91	9	N/A
Maricopa Co. IDA and Phoenix IDA, AZ Series 1982	11.625	GEM:15	90	10	20.8
Jefferson Co., CO 1982 Series A	11.95	GEM:15	90	10	0.0
Cobb Co. HA, GA Series 1982	11.80	GEM:16	90	10	8.1
Prince George's Co. HA, MD 1982 Series A	10.50	GEM:19	92	8	0.0
San Francisco, CA 1982 Bonds Series A	10.75	Level:30	91	9	2.8
Allegheny Co. RFA, PA 1982 Series A	11.375	Level:30	93	7	0.7
Montgomery Co. HOC, MD 1982 Series A	N/A	Level:30	72	28	N/A
Cook Co., IL 1982 Series A and Series B	11.50	GEM:19	92	8	2.2
Los Angeles Co., CA 1982 Issue B	10.625	Level:30	95	5	8.0
Northern Kentucky Series 1982	11.49	Level:20	93	7	0.0

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c. Mortgage interest rates are sometimes lower than the yields on the bonds because of additional funds from fees or contributions from the issuer.

d. Level = level payment mortgage amortized over the specified number of years.
GEM = growing equity mortgage paid off at the end of the specified number of years.

e. ? = There are funds set aside for targeted area loans, but the amount is not specified in the official statement.

Table 3. (Continued)

	Purchase Price Limits for a One-Family Residence in a Nontargeted Area (thousands of dollars)		Below, Equal, or Above IRS Safe-Harbor Purchase Price Limits	Number of Lenders	Income Limit for a Household of Four[f] (thousands of dollars)
	New	Existing			
Palm Springs, CA Issue of 1982	80	---	Equal	1	34
Denton Co., TX Series 1982	100	64	Equal	12	38
Coon Rapids, MN Series 1982	94	94	Above	6	31
Fairbanks North Star, AK Series 1982	101	82	Above	N/A	N/A
Cameron Co., HFC, TX 1982 Series A	74	51	N/A	7	50
Central California MA, 1982 Series A	74	80	N/A	3	32 to 43
Bexar Co. HFC, TX Series 1982	76	64	Equal	14	38
San Mateo Co., CA 1982 Series A	127	119	Above	2	26 to 43
Volusia Co. HFA, FL Series 1982	58	50	Above	4	33
Wichita, KS 1982 Series A	65	46 to 72	Equal	12	No limit
Denver City and Co., CO 1982 Series A	72	63 to 71	Equal	18	42
Atlanta URFA, GA Series 1982	79	74 to 116	Equal or Above	7	30 to 38
Tucson IDA and Pima Co. IDA, AZ Series 1982	75	60	Equal	9	28 to 60
New Castle Co., DE 1982 Series A	68	52	Equal	7	No limit
Broward Co. HFA, FL 1982 Series A	63	63	Equal	7	33
Santa Fe Springs RA, CA 1982 Series A	96	---	Equal	1	N/A
St. Louis, MO Series 1982 A	63	55	Below	12	31
Albuquerque, NM	77	67	Above	5	34
Maricopa Co. IDA and Phoenix IDA, AZ Series 1982	80	72	Equal	33	28 to 60
Jefferson Co., CO 1982 Series A	77	88	Equal	21	42
Cobb Co. HA, GA Series 1982	79	60	Above	13	40
Prince George's Co. HA, MD 1982 Series A	110	103	Above	N/A	N/A
San Francisco, CA 1982 Bonds Series A	114	97	Below	N/A	26 to 50
Allegheny Co. RFA, PA 1982 Series A	85	64	Equal	8	N/A
Montgomery Co. HOC, MD 1982 Series A	70	70	Below	5	35
Cook Co., IL 1982 Series A and Series B	90	78	Equal	27	N/A
Los Angeles Co., CA 1982 Issue B	150	111	Above	2	29 to 44
Northern Kentucky Series 1982	84	64	Above	6	N/A

(Continued)

N/A = The requirement to reserve loan funds for targeted areas was not mentioned in the official statement.

f. When there is a range of income limits within a given locality, the limits generally vary according to geographic location or according to whether the mortgagor is buying new or existing housing.

Mortgage revenue bonds provide financing mostly for detached homes, townhouses, and condominiums. Mortgages may be structured either as traditional 20- to 30-year level-payment mortgages or as growing equity mortgages and accelerated principal payment mortgages, where the mortgagor pays less interest in the beginning years, making it up in the later years.

The bond issue vary in type of obligation—special, limited, or general. The type of obligation depends upon the credit ratings of the state and the issuing agency and upon the issuer's need for added security. On average, about 85 to 90 percent of the total available funds in a given issue went toward mortgage loans. The number of lenders committed to make mortgage loans was larger for state programs and smaller for local programs.

The information below expands on this summary. It is based on the official statements for each issue and telephone conservations with officials of issuing agencies. Additional information was provided by the Office of Financial Management and the State Agency Division, both in the Department of Housing and Urban Development, the General Accounting Office, and the Council of State Housing Agencies. All 1982 state single-family issues together averaged $80 million in 1982, with New York issuing the largest at $250 million and Idaho issuing the smallest at $4.345 million. The average size for all local single-family issues in 1982 was $30 million, with Maricopa County, Arizona, and the City of Phoenix jointly issuing the largest at $113 million, and Raeford, North Carolina, issuing the smallest at $950,000.[6]

Targeted area requirement.—The 1980 Act requires that the lesser of 20 percent of lendable proceeds or 40 percent of the mortgage market share for targeted areas be set aside for mortgages in targeted areas. Targeted areas are qualified low-income census tracts or areas approved by the Secretaries of the Treasury and the Department of Housing and Urban Development to be areas of chronic economic distress. The safe-harbor rule for determining 40 percent of market share in targeted areas is 40 percent of the average annual aggregate principal amount of mortgages in targeted areas within the issuer's jurisdiction during the preceding three years. Of the 40 state issues examined, 15 set aside 20 percent or more of lendable proceeds for mortgages in targeted areas, and 16 used the market-share safe-harbor rule that enabled them to set aside between 0 and 20 percent. Four states has no targeted areas in their jurisdictions or had unpopulated targeted areas and so they did not set aside any proceeds. Information was not available for five states. Of the 28 localities studies, only 2 set aside 20 percent or more, and 13 set aside between 0 and 20 percent. Six localities did not set aside any proceeds for targeted areas because there were none within their jurisdictions, and no mention was made of the targeted area requirement in the official statements of seven others.

Since the regulations came out in July 1981, 40 out of 50 states have applied for approval of additional areas as targeted areas. Thirty-eight of these states have had applications approved. (Localities may not apply independently for areas of chronic economic distress to be approved as targeted areas. Each application must be made by a state governor. The background materials for the application, however, may be prepared by a locality or a housing finance agency.) The 65 newly approved targeted areas and the 30 areas still pending approval vary greatly in size and population. After May 1982, when the Treasury Department removed the cap limiting targeted areas to 20 percent of a state's population, several states applied for additional designated areas to be approved. Applications propose regions as small as city neighborhoods and as large as two-thirds of a state. At present, the population living in targeted areas generally cannot exceed about 50 percent of a state's total population. Federal approval for designating more than half a state as a target area is unlikely because such approval depends upon proving a given area's special chronic economic distress as compared with statewide averages for income, housing stock, and other measures.[7] The 20 percent population cap, however, served to focus the targeting mechanism more narrowly than the present guidelines.

Purchase price limits.—The 1980 act included home purchase price limitations as well as targeted area requirements. The limits are specified as a percentage of the average area purchase price where the home is located. Before the 1980 legislation was amended by TEFRA, the limits were set at 90 percent of the average area purchase price for a home not located in a targeted area and at 110 percent of the average area purchase price for a home located within a targeted area. TEFRA eased these limits by raising them to 110 percent of the average area purchase price for a home not located in a targeted area and to 120 percent of the average area purchase price for a home located within a targeted area.

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[6] There may be some very small local bond issues to be included in the Department of Housing and Urban Development's listing, mainly because of private placements.

[7] Telephone conversations with John Kozak, State Agency Division, Department of Housing and Urban Developing (Mar. 17, 1983 and Apr. 12, 1983).

The IRS issued a listing a safe-harbor estimates of average area purchase prices for issuers to use in calculating purchase price limits.[8] Some 1982 issuers, however, chose to use their own estimates of average area purchase prices for calculating the purchase price limits in their jurisdictions. Twenty-one of the 40 state issues sampled used only the safe-harbor average area purchase prices to determine their purchase price limits. Two states used their own estimates of average area purchase price for some portion of their jursidiction and set limits equal to or above those simply by the safe-harbor estimates. Eight states chose to set their limits below the federal limits for some portion of their jurisdiction. Eight states set the limits for all areas in their jurisdiction below those implied by the safe-harbor estimates and one (Alaska) set all its limit above. Thirteen of the 28 local issues examined adopted purchase price limits determined by the safe-harbor estimates. One issuer (Atlanta) relied on the safe-harbor estimates and its own calculations for different areas, calculating purchase price limits equal to and above those implied by the safe-harbor figures. Nine issuers relief on their own calculations to set all their limits above, and three others chose to set all their limits below those implied by the safe-harbor estimates. Information was not available for two local issuers.

Income limits. Limits on a homebuyer's income are another way state and local governments target their mortgage loan programs. The 1980 act did not include any requirement for income limits, but most issuing jurisdictions studied impose some sort of income limit. For 36 of the state issues sampled, the income limit for a household of four ranged from a lower limit of $16,000 (in Indiana) to an upper limit of $60,000 (in Arizona). Three states—Alaska, New Jersey, and New York—impose no limit on the income of participating mortgagors. Information was only available for 22 out of the 28 local issues sampled. (The other six issues make no mention of income limits in their official statements.) For the 20 local issues that had them, the income limit for a household of four ranged from $26,000 to an upper limit of $60,000. Jurisdictions often set up a range of limits that vary according to family size, geographic area, and whether the mortgagor is buying new or existing housing or whether the mortgagor has special circumstances such as a medical disability. It would appear that localities set income limits less frequently than states, and that when they do set them, those limits are apt to be slightly higher.

Types of housing financed.—Housing agencies issued single-family bonds to finance several types of homes: traditional detached one-family houses, attached townhouses, condominiums, cooperative units, modular homes (permanently affixed manufacturered housing), and owner-occupied two- to four-family houses (when previously occupied). Almost every state and local issuer in the sample allowed financing for comdominiums as well as detached and attached homes. Modular homes are allowed financing by most state programs. but several local issuers do not finance them. One explanation could be that modular homes are often more popular in rural areas where people own land but have little capital to buy housing with. Issuers vary in allowing the financing of existing two- to four-unit family homes. (New two- to four-unit residence are not allowed under MSBTA.) Some issuers restrict multiple-family homes to duplexes or triplexes; several do not provide financing for any multiple-family homes at all. Cooperative units seems to be financed rarely under these bond programs. Coops are uncommon in many parts of the country, and the fact that coop-buyers purchase shares in a corporation rather than an actual physical structure may make many issuers disallow them. The eligibility of coops for tax-exempt financing was clarified in TEFRA.

Housing bonds may be used to provide financing for both new and existing homes. In response to the particular conditions of the housing market in their areas, some issuers limit their programs to all new or all existing homes. Other issuers prescribe specific percentages for new and existing homes, while still others finance mortgage loans on a first-come, first served basis, making a prediction of the percentages for new and existing homes impossible. Local issuers limit their issues to only new housing more frequently than state issuers. In these cases, the intent of the programs is usually to subsidize particular development or redevelopment project where specific builders have been granted contracts.

Type of mortgage.—Mortgages were offered either as conventional level payment mortgages or as growing equity mortgages (GEMs). Growing equity mortgages prescribe growing monthly payments in the first few years (usually five to ten) of the mortgage loan and then level payments for the remainder of the loan. Because the increases in payments go toward paying off principal, these are sometimes called accelerated principal payment mortgages. Fifteen out of 40 state issues studies provided for growing equity mortgages, to be paid off over 16 to 20 years. California offered both 30-year level and 20-year growing equity mortgages. Twenty-four states offered only level-payment mortgages, to be paid off over 14 to 19 years. Twelve offered level-payment mortgages to be paid off over 20 to 30 years, and information was not available for two issues. Single-family mortgage programs using GEMs are often able to attract more homebuyers because of the reduced monthly payments in the early years of the mortgage. Many housing agency officials, however, chose to structure their single-family programs with level-payment mortgages because they felt that potential homebuyers in their region would prefer conventional mortgages to the new and unfamiliar GEMs.

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[8] Department of the Treasury, Internal Revenue Service, News Release No. IR-81-91 (August 6, 1981). An updated listing of average area purchase prices was recently released for bonds issued December 29, 1982 through December 31, 1983. See Department of the Treasury, Internal Revenue Service, News Release No. IR-82-157 (Dec. 29, 1982).

Type of obligation.—The sample of state single-family issues included limited obligation, special obligation and general obligation bonds. The sample of local issues includes limited obligation, special obligation, and special, limited obligation bonds. Limited and special obligation bonds usually have access only to the issuing agency's nonattached assets (mainly the agency's general fund) in case additional money is needed to pay bondholders because of a shortfall in earnings. Attached assets are mortgages and other assets pledged to the payment of other bonds issued by the agency. General obligation bonds usually have some guarantee of support from the state's general funds, if necessary. For some issues, the guarantee was in the form of a so-called moral obligation, where the governor or the state treasurer promises to go to the state assembly to apply for an appropriation in the case of an issue's threatened shortfall, or in the form of guaranteed access to other assets of the agency or the state. Sixteen out of the 40 issues studied were called general obligation bonds while none of the 28 local issues studied was.

Percentage of total funds used for mortgages.—For the state issues sampled, the percentage of total available funds set aside for mortgages averaged 85 percent; the local issues sampled averaged 90 percent. The rest of the funds were used for reserves, the underwriters' discount, original issue discount, capitalized interest, or other costs of issuance. Total available funds include bond proceeds, agency or state contributions, and any fees paid by lenders, builders, buyers, or sellers.

Number of lenders.—Private banks, savings and loans, and mortgage companies request to participate in any given issuer's housing program. The portion of bond proceeds to be used for mortgage loans is allocated to eligible lenders who then commit to loan out their allocation within a prescribed period. Lenders who are unable to loan out their full allocation might have to forfeit a commitment fee and have the remainder of their allocation transferred to another lender. The state issues sampled show a wide dispersion of lending activity; 35 state issues had an average of 110 participating lenders. (Informaton for five states was not available.) The local issues sampled had many fewer participating lenders; for 25 issues, there was an average of 10 lenders participating in each program. The difference between the state and local dispersion of allocations can be explained by the fact that localities are much smaller than states and that local programs are more often organized with a cooperative arangement between the issuer and specific builders and lenders.

APPENDIX TABLES

TABLE A-1. STATE MORTGAGE REVENUE BOND ISSUES FOR OWNER-OCCUPIED HOUSING, 1982

Sale Date	Issue	Amount (thousands of dollars)	Net Interest Cost (percents)	Term	Ratings M	Ratings S&P	Lead Underwriter
	Alabama						
11/11	1982-Series A	100,000	10.76	31*	Al	AA	Goldman Sachs
12/9	1982-Series B	100,000	10.76*	30	Al	AA-	Goldman Sachs
	Alaska						
3/4	Home Improvement Bonds	15,000	13.43*	15	A	A	Salomon Brothers
9/9	1982-First Series	85,000	N/A	18	Aa	AA	Salomon Brothers
11/24	1982-Second Series	100,000	11.54*	17	Aa*	AA-	Salomon Brothers
	Arizona						
11/8	Series A 1982	27,200	9.92*	30		AA-*	Rauscher Pierce Refsnes
	Arkansas						
7/27	1982-Series A	100,000	13.13	20	Al	AA	E.F. Hutton
	California						
3/24	1982-Series	30,000	N/A	N/A	Aa*		Merrill Lynch White Weld
7/23	1982-Series A	31,500	12.95	17	Al	A+	Merrill Lynch White Weld
10/14	1982-Series A	212,000	10.25*	32	Al*	A+	Merrill Lynch White Weld
12/17	1982-Series B	101,775	10.50*	31	Al	A+	Merrill Lynch White Weld
	Colorado						
7/29	1982-Series A	66,050	12.78	19	Aa	AA-	Smith Barney Harris Upham
	Connecticut						
9/10	1982-Series B	150,000	11.06	18	Aa	AA-	Salomon Brothers
9/20	1982-Series	36,600	N/A	30			Goldman Sachs
11/30	1982-Series	50,000	9.73	18*	Aa*	AA	Salomon Brothers
	Delaware						
6/24	1982-Series A	40,000	13.33	22	Aa	AA-	Morgan Guaranty Trust
	Florida						
6/15	1982-Series A	150,000	13.50	18	Al	A	Salomon Brothers
	Georgia						
9/17	1982-Series A	50,000	10.70*	20*	Al	AA	Dean Witter Reynolds
	Hawaii						
7/16	1982-Series A	60,000	13.00	19	Al	A	Merrill Lynch White Weld
	Idaho						
12/17	1982-Series A	4,345	N/A	N/A			Salomon Brothers

(Continued)

TABLE A-1. (Continued)

Sale Date	Issue	Amount (thousands of dollars)	Net Interest Cost (percents)	Term	Ratings M	Ratings S&P	Lead Underwriter
	Illinois						
7/30	1982-Series A	90,000	11.85	18	A1	AA	Smith Barney Harris Upham
	Indiana						
4/6	1982-Series A	75,000	N/A	26	Aa	AA	First Boston Corp.
	Iowa						
9/3	1982-Series A	14,080	11.70	31	A+		Blyth Eastman Paine Webber
	Louisiana						
8/23	1982-Series A	100,000	12.60	32	Aa	AA	E.F. Hutton
	Maine						
6/10	1982-Series B	53,920	12.92	20	A1	AA	Morgan Guaranty Trust
	Maryland						
3/19	1982-Series A	65,000	13.27	32	Aa		Matthews & Wright
10/8	1982-First Series	87,514	10.97	32	Aa*		Salomon Brothers
	Massachusetts						
8/10	1982-Series A	200,000	13.57	32	Aa	A	Blyth Eastman Paine Webber
	Michigan						
4/20	1982-Series	30,000	11.42	15	A	A-	E.F. Hutton
	Minnesota						
6/3	1982-Series A	30,000	12.41	11		A+	Blyth Eastman Paine Webber
8/12	1982-Series B	41,900	11.57	11	A1	A+	Blyth Eastman Paine Webber
11/24	1982-Series C	45,000	N/A	32	A1	A+	Blyth Eastman Paine Webber
12/1	1982-Series A	4,400	N/A	N/A		A+	Blyth Eastman Paine Webber
	Mississippi						
8/20	1982-Series	150,500	11.26	17	A1	A+	Goldman Sachs
	Missouri						
3/31	1982-Series	50,000	13.25	20	Aa	AA	Smith Barney Harris Upham
8/24	1982-Series	49,995	11.09	18	Aa	A+	Morgan Guaranty Trust
	Montana						
4/6	Series 1982 A	55,000	13.50	25	Aa	AA	First Boston Corp.
	Nebraska						
3/29	1982-Series	37,715	12.72	30		AA	Lehman Brothers Kuhn Loeb
6/3	1982-Series A	9,795	12.80	15			Lehman Brothers Kuhn Loeb
7/21	1982-Series B	89,410	11.52	31	Aa	AA	Lehman Brothers Kuhn Loeb

(Continued)

TABLE A-1. (Continued)

Sale Date	Issue	Amount (thousands of dollars)	Net Interest Cost (percents)	Term	Ratings		Lead Underwriter
					M	S&P	
	Nevada						
7/14	1982-Issue A	60,000	14.00	16	A1	AA-	Dean Witter Reynolds
	New Hampshire						
7/1	1982-Series A	167,255	13.06	31	Aa	A+	Kidder Peabody
	New Jersey						
4/14	1982-Series	36,170	13.04	20	A1	A	Goldman Sachs
10/7	1982-Series 1	239,000	10.60	31	A1	A	Goldman Sachs
	New Mexico						
9/1	1982-Series A	98,655	10.54	32	A+	AA	Smith Barney Harris Upham
	New York						
7/8	1982-Series 3	250,000	13.22	30	Aa	A+	Goldman Sachs
12/2	1982-Series 4	151,620	N/A	30	Aa	A+	Salomon Brothers
	North Dakota						
7/15	1982-Series A	29,940	12.77	16	Aa	AA-	Salomon Brothers
	Oklahoma						
12/31	1982-Series A	25,000	8.70*	10*		A+	Stifel Nicolaus
	Oregon						
9/24	1982-Series A	125,000	11.19	31	A1	A+	Blyth Eastman Paine Webber
	Pennsylvania						
4/1	1982-Series A	100,000	13.73	30	A	A+	Goldman Sachs
8/18	1982-Series B	115,000	12.43	31	A1	A+	Goldman Sachs
	Rhode Island						
7/23	1982-Series 1	30,850	13.30	18	A1	A+	Kidder Peabody
12/30	1982-Series 2	41,141	10.11	17*	A1*	A+*	Kidder Peabody
	South Carolina						
9/21	1982-Series A	82,265	N/A	31	Aa	A+	Morgan Guaranty Trust
	South Dakota						
6/3	1982-Series	24,100	13.04	30	Aa	AA	Warburg Paribas Becker
	Tennessee						
7/27	1982-Series A	150,000	12.75	17	A1	A+	Salomon Brothers
	Texas						
7/9	1982-Series A	100,000	13.72	31	Aa	A	Goldman Sachs

(Continued)

TABLE A-1. (Continued)

Sale Date	Issue	Amount (thousands of dollars)	Net Interest Cost (percents)	Term	Ratings M	Ratings S&P	Lead Underwriter
	Utah						
5/28	1982-First Series	121,765	12.68	16	A1	AA	Bache Halsey Stuart Shields
	Vermont						
7/15	1982-Series A	35,000	13.45	27	Aa	AA-	Goldman Sachs
	Virginia						
7/20	1982-Series A	100,000	12.94	32	Aa	A+	Citibank, N.A.
11/9	1982-Series B	166,109	9.42	32	Aa	A+	E.F. Hutton
	West Virginia						
3/5	1982-Series A	25,000	13.85	16	A1	A+	Goldman Sachs
	Wisconsin						
7/1	1982-Series A	100,000	13.80	31	Aa	AA-	Blyth Eastman Paine Webber
12/9	1982-Issue II	50,000	10.67	31	Aa	AA-	Blyth Eastman Paine Webber

SOURCE: Office of Financial Management, Department of Housing and Urban Development.

* This information was provided by the Council of State Housing Agencies.

NOTE: Some of these bond issues may be transitional issues, and therefore not subject to the new rules in MSBTA and TEFRA.

TABLE A-2. LOCAL SINGLE-FAMILY MORTGAGE REVENUE BONDS, 1982

Sale Date	Issuer	Amount (thousands of dollars)	Net Interest Cost (percents)	Term	Ratings		Lead Underwriter
					M	S&P	
1/21	Dade Co., FL	40,000	N/A	14			E.F. Hutton
2/23	Atlanta, GA	49,000	N/A	N/A			E.F. Hutton
3/3	Richmond, CA	59,000	13.12	18	Aa		Dean Witter Reynolds
3/5	Palm Springs, CA	19,300	12.83	31		AA	Shearson/American Express
3/11	Denton Co., TX	25,850	13.55	22		A	Kidder Peabody
3/26	Lancaster, CA	33,400	12.92	19		AA	Miller & Schroeder
3/26	Seal Beach, CA	18,200	N/A	33		AA	Miller & Schroeder
4/7	Orange Co., CA	54,060	13.00	31		AA	Warburg Paribus Becker
4/13	Gregg Co., TX	20,000	13.93	22		A	Kidder Peabody
4/16	Haywood-Union City, CA	22,400	N/A	31		AA-	Stone & Youngberg
4/20	San Diego, CA	35,165	N/A	32		AA	E.F. Hutton
4/22	Harris Co., TX	63,560	13.21	31		AA	Lehman Brothers
4/27	Coon Rapids, MN	30,000	N/A	32		A+	Miller & Schroeder
4/27	Santa Clara Co., CA	34,160	12.38	31		AA	Warburg Paribus Becker
4/28	Capital Area HFC, TX	24,950	13.30	32		AA	Kidder Peabody
4/29	San Pablo, CA	25,200	12.04	13		A	Dillon, Read
4/30	Pittsburg, CA	32,235	N/A	31		A	Dean Witter/Reynolds
4/30	Fairbanks North Star, AK	35,000	N/A	20	Aa	AA	John Nuveen & Co.
5/5	Cameron Co., TX	30,000	N/A	15		A	Boettcher & Company
5/6	Jefferson Co., TX	37,900	N/A	31		A+	Lehman Brothers/Kuhn Loeb
5/10	El Paso, TX	42,500	N/A	15		AA	Rauscher Pierce Refsnes
5/12	Monrovia, CA	9,065	N/A	32		AA	E.F. Hutton
5/13	Clay Co., FL	12,850	N/A	31		A-	William R. Hough
5/14	Hidalgo Co., TX	24,800	13.12	15		A	Boettcher & Company
5/14	Contra Costa Co., CA	62,400	12.87	27		AA	Dean Witter/Reynolds
5/17	Central Texas, TX	17,000	13.17	15		A+	Howard, Weil Labouisse
5/17	Lubbock, TX	25,000	13.17	15		A+	Howard, Weil Labouisse
5/17	Midland Co., TX	20,000	13.12	15		A+	Howard, Weil Labouisse
5/17	Tarrant Co., TX	43,855	N/A	31	Aa	AA-	Lehman Brothers Kuhn Loeb
5/18	Sacramento Co., CA	31,900	N/A	32			Blyth Eastman Paine Webber
5/18	Benton Co., TX	30,815	10.00	32		AA	Kidder Peabody
5/20	Ventura Co., CA	36,200	N/A	21		A+	Miller & Schroeder Municipals
5/20	Central Calif., CA	30,000	N/A	30		AAA	Shearson/American Express
5/25	Bexar Co., TX	69,210	N/A	17		A	Boettcher & Coompany
6/3	Orange Co., FL	34,800	12.82	17		A+	Merrill Lynch/White Weld
6/3	Livermore/ San Leandro, CA	35,820	12.60	33		AA-	Shearson/American Express
6/8	San Mateo Co., CA	40,860	13.01	31		AA-	First Boston Corp.
6/10	Volusia Co., FL	11,905	N/A	14		A	William R. Hough
6/10	Pittsburgh, PA	15,000	13.34	31	A1	A	Dillon, Read & Company
6/16	Corpus Christi, TX	30,000	N/A	31		AA	E.F. Hutton
6/18	Southeast Texas, TX	60,000	13.17	15		A+	Howard, Weil Labouisse
6/23	Wichita, KS	30,000	N/A	18	A1	AA	E.F. Hutton
6/23	Concord-Walnut Creek, CA	32,000	13.01	32		AA-	E.F. Hutton
6/24	Escambia, FL	26,830	N/A	31		A	William R. Hough

(Continued)

TABLE A-2. (Continued)

Sale Date	Issuer	Amount (thousands of dollars)	Net Interest Cost (percents)	Term	Ratings		Lead Underwriter
					M	S&P	
6/25	Palm Beach Co., FL	26,370	13.59	16		AA	Merrill Lynch/White Weld
6/29	Denver (City and County), CO	26,625	N/A	16		A	E.F. Hutton
6/29	Manatee Co., FL	6,830	N/A	N/A			William R. Hough
6/30	Polk Co., Fl	11,925	N/A	31		A+	William R. Hough
7/9	Orange Co., CA	49,150	N/A	33		AA	Warburg Paribus Becker
7/12	Simi Valley, CA	50,000	N/A	33		AA-	Stone & Youngberg
7/12	Ontario, CA	31,200	N/A	33		AA-	Miller & Schroeder
7/15	Tulare Co., CA	31,200	N/A	32		A+	Dean Witter/Reynolds
7/16	Atlanta, GA	30,000	N/A	16	A1	AA-	Merrill Lynch/White Weld
7/16	Olathe, KS	30,000	13.10	32		AA	Blyth Eastman/Paine Webber
7/19	Tucson and Pima Cos., AZ	51,875	11.54	17		AA-	Rauscher Pierce Refsnes
7/21	Brevard Co., Fl	30,000	N/A	22		AA-	Kidder Peabody
7/21	San Bernardino Co., CA	58,750	N/A	33		AA-	Miller & Schroeder
7/22	Lee Co., Fl	20,090	13.43	22		AA-	Bache Halsey Stuart Shields
7/23	New Castle Co., DE	50,000	13.31	25		AA	L.F. Rothschild
7/26	Oakland, CA	61,740	13.10	31			Goldman Sachs
7/29	Broward Co., Fl	34,300	13.59	17	A1	A+	Merrill Lynch/White Weld
7/30	Los Angeles Co., CA	53,200	N/A	33		AA-	Warburg Paribus Becker
8/3	Santa Fe Springs, CA	9,580	12.51	25		AAA	L.F. Rothschild
8/3	West Covina-Baldwin Park, CA	18,900	12.76	17		A+	Rauscher Pierce Refsnes
8/6	St. Louis Co., MO	21,180	12.66	32		A+	Stifel, Nicolaus
8/6	St. Charles Co., MO	23,300	N/A	32		A+	Geo. K. Baum
8/12	Los Angeles, CA	30,000	N/A	32			Salomon Brothers
8/18	Adams Co., CO	10,595	N/A	16		A+	E.F. Hutton
8/18	Pleasanton-Newark, CA	25,340	N/A	31		AA	Dean Witter/Reynolds
8/20	Fresno Co., CA	38,000	N/A	30			Goldman Sachs
8/23	Albuquerque, NM	19,100	11.83	16		A+	E.F. Hutton
8/27	Maricopa Co/Phoenix, AZ	113,000	N/A	18	A1	AA-	Rauscher Pierce Refsnes
8/31	Jackson Co., MO	25,900	N/A	32			Stern Brothers & Co,
9/2	St. Louis, MO	20.180	N/A	30			Drexel, Burnham Lambert
9/3	Northern California	60,000	12.94	20		AA-	Dean Witter/Reynolds
9/3	Jefferson Parish, LA	19,175	N/A	20		AA	Shearson/American Express
9/8	Kern Co., CA	29,200	N/A	N/A		AAA	Shearson/American Express
9/10	Pittsubrgh, PA	11,000	N/A	N/A		A	Dillon, Read & Company
9/13	Jefferson Co., CO	19,875	N/A	17		A+	E.F. Hutton
9/15	Baltimore, MD	50,000	11.75	N/A		AA	Alex Brown & Sons
9/15	Stockton-Vacaville, CA	19,540	11.75	32			Shearson/American Express
9/17	Orange Co., CA	26,135	N/A	33		AA	Warburg Paribus Becker
9/27	Baltimore, MD	4,600	11.25	10			Baker, Watts & Company
10/1	Cobb Co., GA	10,165	11.04	16			Merrill Lynch/White Weld
10/1	Dekalb Co., GA	10,040	11.04	16			Merrill Lynch/White Weld
10/1	Gwinnet Co, GA	7,615	11.04	16			Merrill Lynch/White Weld
10/1	Reno Co., KS	20,000	N/A	21		AAA	Kirchner, Moore & Company

(Continued)

TABLE 2. (Continued)

Sale Date	Issuer	Amount (thousands of dollars)	Net Interest Cost (percents)	Term	Ratings M	Ratings S&P	Lead Underwriter
10/8	Prince George's Co., MD	35,950	N/A	20		A+	Baker, Watts & Company
10/8	City & Co. San Francisco, CA	60,000	N/A	32			Shearson/American Express
10/13	El Paso Co., CO	15,295	N/A	N/A			Boettcher & Company
10/13	Los Angeles, CA	20,700	N/A	N/A		AAA	Shearson/American Express
10/14	E. Baton Rouge, LA	30,000	N/A	20		AA-	Shearson/American Express
10/15	Milpitas, CA	15,555	9.68	20		A	Miller & Schroeder
10/21	St. Cloud, MN	10,000	N/A	20		A	Dain Bosworth
10/21	Sauk Rapids, MN	8,000	N/A	20		A	Dain Bosworth
11/1	Saline Co., KS	32,540	N/A	32		AAA	Kirchner Moore
11/3	Marin Co., CA	9,300	N/A	32		A-	Shearson/American Express
11/12	Allegheny, PA	25,000	N/A	32			Russell, Rea & Zappala
11/15	San Bruno, CA	91,000	N/A	N/A			Shearson/American Express
11/15	Kansas City, KS	19,000	N/A	32			Stern Brothers
11/17	Pasadena, CA	33,325	N/A	29			Shearson/American Express
11/18	Duluth, MN	1,000	N/A	12			Dain Bosworth
12/1	Raeford, NC	950	N/A	N/A			Wertheim and Co.
12/2	Labette Co., KS	14,165	N/A	12			Kirchner, Moore & Company
12/2	St. Paul, MN	16,500	N/A	32			Piper, Jaffray & Hopwood
12/3	Montgomery Co., MD	37,495	N/A	32			Merrill Lynch/White Weld
12/3	Ventura Co., CA	33,800	N/A	22		A+	Miller & Schroeder
12/8	Cook Co., Il	70,000	N/A	20	Al		Ist Nat'l. Bank of Chicago
12/14	Los Angeles Co., CA	75,000	N/A	28			Blyth Eastman/Paine Webber
12/20	Santa Rosa-Martinez, CA	19,000	N/A	32		A+	Dean Witter/Reynolds
12/20	Santa Cruz-Hayward, CA	21,370	N/A	N/A			Miller & Schroeder
12/21	Northern Kentucky, KY	15,750	N/A	18			Fox, Reusch
12/21	Cook Co., Il	31,075	N/A	29		AAA	Blyth Eastman/Paine Webber
12/27	Brooklyn Center, MN	31,758	N/A	32		AA	Miller & Schroeder
12/27	Boulder Co., CO	10,000	N/A	18			E.F. Hutton
12/30	Mesa Co., CO	14,450	N/A	17		A-	George K. Baum & Company
12/30	Floyd and Johnson Cos., KY	15,250	N/A	N/A			Seasongood and Mayes

SOURCE: Office of Financial Management, Department of Housing and Urban Development.

NOTE: Some of these bond issues may be transitional issues, and therefore not subject to the new rules in MSBTA and TEFRA.

TABLE A-3. VETERANS' GENERAL OBLIGATIONS BONDS, 1982

Sale Date	Issuer	Amount (thousands of dollars)	Net Interest Cost (percents)	Term	Ratings		Lead Underwriter
					M	S&P	
5/21	California	50,000	10.93	N/A	Aa	AA	Bank of America
8/3	Oregon	100,000	10.47	N/A	A1	AA	Morgan Guaranty Trust
8/24	California	100,000	9.44	N/A	Aa	AA+	Bank of America
8/25	Wisconsin	30,000	9.20	N/A	Aa		Smith Barney Harris Upham
11/1	Oregon	200,000	N/A	N/A	A1	AA	Salomon Brothers

SOURCE: Office of Financial Management, Department of Housing and Urban Development.

TABLE A-4. STATE MORTGAGE REVENUE BOND ISSUES FOR MULTIFAMILY, RENTAL HOUSING, 1982

Sale Date	Issue	Amount (thousands of dollars)	Net Interest Cost (percents)	Term	Ratings		Lead Underwriter
					M	S&P	
	Alaska						
8/2	1982-Series A	2,390	13.18	41		AA	John Nuveen & Co.
	Arkansas						
6/17	1982-Series A	153,075	12.42	41	Aa	AA	E.F. Hutton
	California						
6/1	1982-Series	45,600	12.42	42		AA	Merrill Lynch White Weld
9/10	1982-Series A	75,090	11.25	42	A1		Merrill Lynch White Weld
11/12	1982-Series B	31,845	N/A	32	A1*	AAA	Merrill Lynch White Weld
	Colorado						
5/13	1982-Series A	104,735	11.12	43	Aa	AA	Smith Barney Harris Upham
10/20	1982-Series B	28,780	8.54*	42		AA+	Smith Barney Harris Upham
11/17	1982-Series A	32,000	9.50*	12*		AAA-L*	Smith Barney Harris Upham
	Connecticut						
4/2	G.O. Bonds	75,000	11.10	N/A			Citibank
4/23	1982-Series	51,270	12.62*	32	Aa	AA-	Salomon Brothers
	Delaware						
9/24	1982-Series A	71,900	10.97	32	A+	A+	Salomon Brothers
	District of Columbia						
8/10	1982-Series	57,480	12.22	40	Aa	AA+	Salomon Brothers
	Florida						
6/29	1982-Series A	47,000	13.23	42	Aa	AA	Merrill Lynch White Weld
9/28	1982-Series B	3,435	N/A	42*	Aa*	AA*	William R. Hough & Company
12/1	1982-Series ABC	31,350	10.00*	20		AAA	Merrill Lynch White Weld
	Illinois						
4/7	1982-Series A	88,420	N/A	31	A	A+	Smith Barney Harris Upham
6/10	1982-Series B	64,260	10.39	44	A1	AA	Smith Barney Harris Upham
11/24	1982-Series C	72,090	N/A	43	A1*	AA*	Smith Barney Harris Upham
	Indiana						
8/12	1982-Series	8,790	13.05	42	Aa*		First Boston Corp.
	Iowa						
9/27	1982-Series C	17,555	11.07	40		Aa	Blyth Eastman Paine Webber

(Continued)

TABLE A-4. (Continued)

Sale Date	Issue	Amount (thousands of dollars)	Net Interest Cost (percents)	Term	Ratings		Lead Underwriter
					M	S&P	
	Louisiana						
8/23	1982-Series A	73,640	11.82	42	Aa	AA	E.F. Hutton
	Maine						
2/25	1982 Series	23,280	13.68	31	A1	AA	Salomon Brothers
10/13	1982-Series C	5,340	N/A	32			Private Placement
11/24	1982-Series D	2,190	N/A	31			Private Placement
	Maryland						
5/7	1982-Series A	32,335	N/A	42	Aa		Matthews & Wright
7/29	1982-Series B	16,510	N/A	42	Aa		Merrill Lynch White Weld
8/18	1982-Series	34,500	N/A	20			Alex Brown & Sons
9/14	1982-Series C	66,740	11.13	20	Aa*		Merrill Lynch White Weld
	Massachusetts						
5/21	1982-Series A:3	37,890	12.38*	32	A1	A+	Blyth Eastman Paine Webber
9/1	1982-Series A	17,700	11.72	42	Aa*	AA*	Blyth Eastman Paine Webber
9/17	1982-Series A:4	63,000	11.76	32	A1*	A+*	Blyth Eastman Paine Webber
12/16	1982-Series B:4	45,300	N/A	31			Blyth Eastman Paine Webber
	Michigan						
7/21	1982-Series	32,670	N/A	33	A1	A+	E.F. Hutton
	Minnesota						
3/3	1982-Series A	40,920	13.56	32	A1	A+	Blyth Eastman Paine Webber
4/15	1982-Series B	7,210	N/A	N/A			Blyth Eastman Paine Webber
8/1	1982-Series C & D	9,575	N/A	N/A			Private Placement
	Missouri						
9/27	1982-Series	1,025	13.97	31			Salomon Brothers
5/18	1982-Series	7,425	9.58*	42		AA*	Salomon Brothers
	Montana						
5/27	Series 1982A	1,945	12.91*	40	Aa*		First Boston Corp.
	Nebraska						
9/10	1982-Series	2,945	N/A	41		AAA*	Lehman Brothers Kuhn Loeb
	Nevada						
2/8	1982-Series	2,180	14.00	34	Aa	AAA	Dean Witter Reynolds
4/15	1982-Series	3,105	11.00*	32			Dean Witter Reynolds
10/26	1982-Series B	2,625	N/A	32	Aa	AAA	Dean Witter Reynolds

(Continued)

TABLE A-4. (Continued)

Sale Date	Issue	Amount (thousands of dollars)	Net Interest Cost (percents)	Term	Ratings		Lead Underwriter
					M	S&P	
	New Hampshire						
3/19	1982-Series	35,415	13.16	32	A1	A+	Kidder Peabody
9/16	1982-Series 2	1,650	12.60	31	A1	A+	Private Placement
	New Jersey						
10/_	1982A	4,570	9.50*	31			Private Placement
11/1	1982 A	9,470	12.00*	32		AA*	Bear Sterns
	New York						
1/6	1982-Series	2,515	13.38	41	Aa	AAA	L.F. Rothschild
5/7	1982-Series	53,650	12.75	40	Aa	AAA	Salomon Brothers
8/13	1982-Series B	40,950	11.22	42	Aaa*	AAA	Salomon Brothers
8/20	1982-UDC Series A	12,000	N/A	10			Dillon Reed
12/2	1982-Series A	6,550	10.67*	42	Aa*	AA	Private Placement
	North Carolina						
4/8	1982-Series	7,420	N/A	N/A			Alex Brown & Sons
5/13	1982-Series A	52,000	9.95*	42	Aa	AAA	Alex Brown & Sons
	North Dakota						
11/23	1982-Series	11,365	9.22	8		AAA+*	Rauscher Pierce Refsnes
	Oregon						
5/4	1982-Series	17,740	12.07	41	Aa	AA	Kidder Peabody
10/13	1982-Series	47,150	9.48	42	A1	AA	Salomon Brothers
	Pennsylvania						
1/28	1982-Series J	24,640	14.56	31	A1	A+	Goldman Sachs
3/26	1982-Series K	22,500	13.72	31		A+	Goldman Sachs
7/8	1982-Series	62,370	12.98	42	Aa	A+	Goldman Sachs
9/2	1982-Series L	28,730	N/A	43	A1*	A+*	Goldman Sachs
10/29	1982-Series B	14,210	9.70	N/A	A	A+	Goldman Sachs
11/19	1982-Series M	20,835	N/A	32	A1	A+	Goldman Sachs
	Puerto Rico						
3/15	1982-Series	75,000	12.34	27	Aa	AAA	Lehman Brothers Kuhn Loeb
	Rhode Island						
5/27	1982-Series A	50,155	12.85	27	A1	A+	Kidder Peabody
	South Carolina						
6/25	1982-Series A	24,960	11.47*	43	Aaa*	AA*	Morgan Guaranty Trust
9/7	1982-Series B	5,160	11.69*	43	Aaa*	AA*	Morgan Guaranty Trust

(Continued)

TABLE A-4. (Continued)

Sale Date	Issue	Amount (thousands of dollars)	Net Interest Cost (percents)	Term	Ratings		Lead Underwriter
					M	S&P	
	South Dakota						
3/15	1982-Series	13,595	N/A	40			A.G. Becker
	Texas						
10/15	1982-Series	69,920	9.55*	23*	Aa		Goldman Sachs
	Utah						
5/6	1982-Series A	17,015	12.93*	42		AA*	Blyth Eastman Paine Webber
10/14	1982-Series B	5,565	9.94	42		AA*	Bache Halsey Stuart Shields
	Vermont						
5/27	1982-Series	8,250	12.96	32	A1*	A	Goldman Sachs
	Virginia						
6/15	1982-Series A	256,970	11.50	35	A1	AA	E.F. Hutton
	West Virginia						
3/25	1982-Series	4,055	13.75	31		A	Goldman Sachs
9/14	1982-Series	1,785	11.62	21			Goldman Sachs
12/3	1982-Series A	22,450	N/A	42	Aa	AA	Goldman Sachs
	Wisconsin						
3/18	1982-Series	76,725	13.37	32	A1	A+	Smith Barney Harris Upham
	Wyoming						
5/26	1982-Series A	3,270	13.09*	42		AA*	First Boston Corp.
9/17	1982-Series B	2,710	N/A	41			First Boston Corp.
12/17	1982-Series C	2,430	N/A	41		AA	First Bonston Corp.

SOURCE: Office of Financial Management, Department of Housing and Urban Development.

* The Council of State Housing Agencies provided this information.

NOTE: Some of these issues may be transitional and therefore not subject to the new rules in MSBTA and TEFRA.

TABLE A-5. LOCAL NON-11b ISSUES FOR MULTIFAMILY, RENTAL HOUSING, 1982

Sale Date	Issuer	Amount (thousands of dollars)	Net Interest Cost (percents)	Term	Ratings M	Ratings S&P	Lead Underwriter
1/4	Clay County, FL	12,000	N/A	11	A1		William R. Hough
2/18	Panhandle Regional TX	17,005	12.26	7	Aaa		Kidder Peabody
2/22	Atlanta, GA	49,000	N/A	20	Aaa		E.F. Hutton
3/8	Tarrant Co., TX	48,800	11.63	N/A	Aaa		Lehman Brothers Kuhn Loeb
3/15	Maricopa Co., AZ	75,300	N/A	N/A			N/A
3/16	St. Louis Co., MO	23,840	N/A	N/A			Kirchner Moore
3/18	Los Angeles, CA	18,040	N/A	N/A			Sutro and Co.
4/16	Ontario, CA	5,000	N/A	25	Aaa		Dean Witter Reynolds
4/20	Oklahoma Co., OK	63,900	N/A	N/A	Aaa		Kidder Peabody
4/22	Phoenix, AZ	7,000	N/A	N/A			Dillon Reed
4/23	New York City, NY	173,775	N/A	42			Goldman Sachs
4/26	Dade Co., FL	2,595	N/A	10		BBB	Arch W. Roberts
4/29	El Paso, TX	6,290	N/A	N/A			Rauscher Pierce Refsnes
4/29	Harris Co., TX	20,655	N/A	N/A			Rauscher Pierce Refsnes
4/29	Odessa Co., TX	8,530	N/A	N/A	Aaa		Rauscher Pierce Refsnes
5/1	Oakland, CA	2,925	N/A	15	Aaa		N/A
5/3	Nassau Co., FL	5,760	N/A	7		A	William R. Hough
5/4	St. Tammany, LA	20,915	N/A	N/A	Aaa		Howard, Weil Labouisse
5/7	Austin/Midland/ Bexar, TX	25,470	N/A	20	Aa1	AA-	First Southwest Company
5/12	Volusia Co., FL	7,090	N/A	11	A1		William R. Hough
5/17	Minneapolis, MN	21,100	N/A	11	Aa1		Dain Bosworth
5/17	Tarrant Co., TX	22,895	N/A	N/A	Aaa		Lehman Brothers Kuhn Loeb
5/18	Gurnee, Il	11,235	N/A	N/A			Boettcher and Co.
6/1	Norwalk, CA	3,195	N/A	N/A			Boettcher and Co.
6/8	Spartanburg, SC	3,495	N/A	10			Matthews & Wright
6/22	Loma Linda, CA	4,000	12.46	N/A	A1		Miller & Schroeder
6/28	Evanston, WY	8,365	N/A	N/A		AA	E.F. Hutton
6/30	Dade City, FL	11,300	N/A	30			Buchanan & Company
7/15	New Bedford, MA	5,615	N/A	N/A			Kirchner Moore
8/9	Salinas-Monterey-Marina, CA	9,685	N/A	32		A-	Stone and Youngberg
8/12	Lancaster, SC	1,928	N/A	N/A			Interstate Securities Corp.
8/13	Port Arthur, TX	8,150	N/A	N/A		AAA	Boettcher and Co.
8/27	Palm Beach, FL	40,000	11.75	N/A			William R. Hough
8/27	Prince George's Co., MD	29,600	N/A	24		A-	Cranston Securities
9/9	Orange Co., CA	2,375	N/A	15		AAA	1st Interstate Bank of CA
9/14	Albany, NY	14,690	N/A	30			Bankers Trust
9/15	Los Angeles, CA	10,165	N/A	32		AAA	Dain Bosworth
9/22	St. Paul, MN	5,800	N/A	10			Piper, Jaffery & Hopewood
9/24	Allentown, PA	4,560	N/A	32			L.F. Rothschild
9/29	Montgomery Co., MD	12,500	N/A	22	A		Merrill Lynch/White Weld
9/30	Orange Co., CA	7,605	N/A	N/A			1st Interstate Bank of CA
10/12	Los Angeles, CA	45,775	N/A	N/A			Kidder Peabody
10/18	Palm Beach, FL	24,950	N/A	N/A			William R. Hough
10/19	Tulsa Co., OK	10,930	N/A	N/A		AAA-L	Rotan Mosle Inc.
10/28	New York City, NY	35,215	N/A	N/A			Blyth Eastman Paine Webber

(Continued)

TABLE A-5. (Continued)

Sale Date	Issuer	Amount (thousands of dollars)	Net Interest Cost (percents)	Term	Ratings M	Ratings S&P	Lead Underwriter
10/26	Pulaski Co., AR	21,340	N/A	N/A		AAA-L	Shearson/American Express
11/3	Tulsa Co., OK	8,290	N/A	N/A			Shearson/American Express
11/9	Tulsa Co., OK	24,880	N/A	N/A		AAA-L	Rotan Mosle, Inc.
11/18	Howard Co., MD	6,100	N/A	N/A			Baker, Watts and Co.
11/22	Pima Co., AZ	31,800	N/A	10		AAA	Rauscher Pierce Refsnes
11/23	Panhandle Regional, TX	42,200	N/A	12		AAA-L	Kidder Peabody
11/29	Canadian Co., OK	9,175	N/A	N/A		AAA-L	Rotan Mosle, Inc.
11/29	Orange Co., CA	7,315	N/A	N/A			Ist Interestate Bank of CA
12/1	Philadelphia, PA	8,000	N/A	N/A			Merrill Lynch White Weld
12/1	Oakland, CA	16,600	N/A	N/A		AAA-L	E.F. Hutton
12/1	San Bernadino, CA	7,005	N/A	14		AAA	Cranston Securities
12/1	Grady Co., OK	2,850	N/A	12		AAA-L	Leo Oppenheim & Company
12/1	Comanche Co., OK	5,215	N/A	12		AAA-L	Leo Oppenheim & Company
12/1	Jackson Co., OK	2,850	N/A	12		AAA-L	Leo Oppenheim & Company
12/1	Lakewood, CO	17,970	N/A	N/A		AAA-	Boettcher and Company
12/2	Allegheny Co., PA	1,800	N/A	31		AAA	Russell Rea & Zappola
12/2	Austin, TX	26,630	N/A	20	Aa		E.F. Hutton
12/6	Clay Co., TX	20,000	N/A	N/A		AAA-L	Kidder Peabody
12/8	Escambia Co., FL	4,830	N/A	11		AAA	William R. Hough
12/10	Abilene, TX	7,530	N/A	N/A		AA+	Rotan Mosle, Inc.
12/10	Harris Co., TX	30,175	N/A	10		AAA-L	Rauscher Pierce Refsnes
12/10	Travis Co., TX	11,700	N/A	10		AAA-L	Rauscher Pierce Refsnes
12/10	Galveston, TX	9,920	N/A	10		AAA-L	Rotan Mosle, Inc.
12/10	Pulaski Co., AR	18,265	N/A	N/A		AAA-L	Shearson/American Express
12/10	Harris Co., TX	33,300	N/A	N/A			Bankers Trust Co.
12/13	DeSoto, TX	8,090	N/A	N/A		AAA-L	Rotan Mosle, Inc.
12/14	Southeast Texas, TX	39,495	N/A	N/A			Shearson/American Express
12/15	San Buenaventura, CA	16,000	N/A	15		AAA-L	Shearson/American Express
12/15	Clay Co., FL	20,000	N/A	N/A			Merrill Lynch White Weld
12/16	Gregg Co., AR	9,575	N/A	12		AAA-L	Kidder Peabody
12/16	Denton Co., TX	29,065	N/A	N/A			Kidder Peabody
12/17	Minneapolis, MN	12,000	N/A	N/A			Dain Bosworth
12/17	Vista, CA	8,710	N/A	15		AAA-L	Shearson/American Express
12/17	San Diego, CA	19,655	N/A	23			Goldman Sachs
12/18	Heart of Texas, TX	23,000	N/A	12		AAA-L	Kidder Peabody
12/21	New Orleans, LA	18,555	N/A	13		AAA-L	Shearson/American Express
12/21	Southeast Texas, TX	39,495	N/A	10		AAA-L	Rotan Mosle Inc.
12/22	Midland, TX	17,470	N/A	12		AAA-L	Rotan Mosle Inc.
12/22	Kern Co., CA	2,498	N/A	N/A			Security Pacific Nat'l. Bank
12/23	San Bernardino, CA	7,005	N/A	24		AAA	Cranston Securities, Inc.
12/28	Harris Co., AR	23,260	N/A	10		AAA-L	Rauscher Pierce Refnses
12/28	DeKalb Co., GA	18,700	N/A	22		AAA	Dean Witter
12/29	Napa Co., CA	3,125	N/A	19		AAA	Newman Associates
12/30	Santa Rosa, CA	5,870	N/A	15		AAA	Newman Associates
12/30	St. Louis, MO	4,320	N/A	11		AA-	Mercantile Trust

SOURCE: Office of Financial Management, Department of Housing and Urban Development.

NOTE: Some of these issues may be transitional, and therefore not subject to the new rules of MSBTA and TEFRA.

Mr. Frenzel. Thank you very much.

Mr. Gibbons. Dr. Rivlin, you are excused. I would add to all those nice things people have said about you.

We will have to quit for a while here now. We have a quorum call, a real one, and I will be right back.

[Recess.]

Mr. Pickle [presiding]. I will ask the committee to come to order again and our guests please take their seats.

When we stopped consideration of the hearing, a vote was being held on the floor. Dr. Rivlin had just finished her statement. Now we are pleased to hear—receive the statement of Mr. Baltas E. Birkle, Deputy Director for Operations of the GAO.

Mr. Birkle, we would be glad for you to present your testimony now.

STATEMENT OF BALTAS E. BIRKLE, DEPUTY DIRECTOR FOR OPERATIONS, RESOURCES, COMMUNITY AND ECONOMIC DEVELOPMENT DIVISION, GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY WILLIAM J. GAINER, ISSUE AREA PLANNING DIRECTOR, RESOURCES, COMMUNITY AND ECONOMIC DEVELOPMENT DIVISION, AND LARRY HIRSCHLER, SENIOR EVALUATOR, LOS ANGELES REGIONAL OFFICE

Mr. Birkle. Mr. Chairman, we have a rather lengthy statement with exhibits, that we have submitted for the record. I have a much shorter version that I will read for the purposes of the testimony.

Mr. Pickle. Your entire statement will be included in the record, Mr. Birkle.

Mr. Birkle. We appreciate being asked to assist your committee in considering some of the policy and technical issues surrounding the use of mortgage subsidy bonds. With me here at the witness table are: Mr. William Gainer, who is our Housing and Community Development Issue Area Planning Director; and Mr. Larry Hirschler, senior evaluator from our Los Angeles regional office.

Our remarks today will parallel and expand somewhat upon the information provided to the chairman of the Senate Committee on Finance in a report dated April 18, 1983. That report was written to answer the chairman's questions regarding the extent to which low- and moderate-income home buyers have been assisted by mortgage subsidy bonds, the effectiveness of Federal purchase price ceilings and locally imposed income ceilings in targeting program benefits, and the economic efficiency of mortgage subsidy bonds in general.

Overall, our analysis indicates that mortgage subsidy bonds are very costly when compared to the benefits they provide to assisted home buyers and to the cost of other alternatives which could provide the same level of assistance. We also found that the public purpose objective of subsidizing low- and moderate-income households who need assistance to purchase homes is not generally achieved.

In our statement today we take no position on whether or not subsidies should be made available to facilitate low- and moderate-income home ownership. Rather, we note that if Congress wishes to continue to provide such subsidies, there are more economical ways to do so than with mortgage revenue bonds.

We also believe it would make sense to limit such subsidies to those first-time home buyers who could not otherwise buy homes.

With regard to the overall economic efficiency of mortgage revenue bonds, we found them to be quite costly to the Federal Government when compared to the benefits provided buyers and to the possible costs of alternative subsidy mechanisms which could be employed.

In all our calculations, the costs of mortgage revenue bonds in 1982 were estimated to be substantially greater than the benefits to home buyers, with cost estimates ranging from about three to six times the benefits. The major reason for this is that tax-exempt housing bonds provide large tax savings to bond purchasers and profits for many financial and legal intermediaries. Using a tax credit or a direct grant to lenders, Federal costs could be substantially reduced to a level roughly equal to the cash value of the mortgage interest savings to home buyers.

We have a chart which portrays some of the information that I have just been saying. That chart is exhibit 1 in the detailed statement. We calculated that the present value of lost tax revenues related to revenue bond loans made in 1982 will average at least $13,300 per loan, based on an average mortgage of about $43,300. The cash value of the subsidy to home buyers is about $50 per month.

By contrast, this benefit could be provided as a $3,400 one-time grant to buy down the conventional mortgage interest rate, or through yearly tax credits with a present value cost of about $3500. The approximately $10 billion raised with revenue bonds for home loans in 1981 and 1982 could result in tax revenue losses of $2.66 billion in present value. A direct subsidy program providing the same number of loans could have been funded for about $680 million, a savings of approximately $2 billion.

The structure of the mortgage revenue bond subsidy, normally a fixed interest rate reduction to all buyers, is inherently inequitable. The higher the income of the buyer and the less likely the buyer is to need help, the more they receive in subsidy and the greater the cost incurred by the Government. This is because higher income buyers generally buy more expensive homes than those with modest incomes.

For a household earning about $20,000 annually, the subsidy was worth $480 per year, while a household earning $40,000 received a yearly interest reduction of about $820. To subsidize the $20,000 income purchaser's home with a mortgage of $34,900 will over time cost the Treasury roughly $10,700, while subsidizing the $40,000 income purchaser's home with a $60,000 mortgage will have a present value cost to the Treasury of $18,400.

We have another chart, which is exhibit 3 in the detailed statement, based on 1982 statistics, which showed that the largest share, about 74 percent of the costs of the mortgage revenue bonds, went to benefit high-income bond purchasers, bond underwriters, lawyers, and other intermediaries, rather than to the home buyers. Only 26 percent of the cost resulted in benefits to home buyers.

In contrast, providing the same households with the same assistance they received in 1982, but using a more efficient subsidy such as a tax credit, could have reduced the proportion of subsidy lost to delivery expenses to less than 6 percent, leaving 94 percent to benefit home buyers.

We estimate that with the lower interest rates in 1983 the proportion of costs going to benefit bond purchasers and intermediaries will still exceed 57 percent.

We found that most subsidized home loans were not made to low- and moderate-income households in need of assistance, but rather to middle-income households who probably could have purchased homes without assistance.

In gauging whether or not this group of home buyers needed assistance or how their incomes compared to the general population, the national statistics on purchaser's incomes and median home prices are nearly meaningless. One must, rather, consider the geographic locations of the individual home buyers and their family sizes. When family size and location within the State are taken into account, 78 percent of all loan recipients were above median income in the local areas in which they resided. And using Congress' definition of low and moderate income for assisted housing programs, only about 6 percent could have been classified as low and moderate income.

Without stringent income limitations, one would expect some mortgage revenue bond home buyers to buy about what they would have without the subsidy, merely reducing their monthly payments without any significant change in their housing consumption. To explore this possibility, we determined which of the 7,600 mortgage bond home buyers in seven States had incomes high enough to have qualified for market interest rate mortgage loans in 1982.

Applying the same debt to income criteria used by lenders in granting mortgage revenue bond loans, we estimated that 88 percent of the 1982 mortgage revenue bond purchasers could have qualified for loans at a 15.5 percent interest rate, which is above the average rate for loans closed by both mortgage bankers and savings and loan associations in 1982.

Even using a 16.5 percent interest rate, which is the highest rate actually experienced in 1982, and a restrictive debt to income ratio, 40 percent of bond-assisted purchasers could still have bought the same homes without subsidy.

These figures establish a range, but our best estimate using these and a variety of other measures is that at least 75 percent of revenue bond assisted households could have purchased the same homes without assistance in 1982. Had most of the remaining households chosen to wait only a few months, bought a slightly less expensive home, or used a graduated payment mortgage, which substantially increases affordability, they very likely could have also purchased during 1982 without subsidy.

Effective income and purchase price ceilings could very likely have enhanced the targeting of program benefits under mortgage revenue bonds. But the shallow interest subsidy provided by bonds would still have limited the ability of mortgage revenue bonds to reach those households who could not otherwise have purchased homes without assistance.

One contention made by mortgage revenue bond proponents is that the income ceilings for loans were raised out of necessity in 1981 and 1982 because of the unusually high mortgage interest rates. To examine this, we analyzed information on income ceilings during three periods—pre-1980, 1981–82, and thus far in 1983. This information leads us to two conclusions:

Although income targeting varies substantially from issuer to issuer, State and local income limits for mortgage revenue bond loans have not been set during any of these periods so as to limit participation to low- and moderate-income households in need of assistance.

Income limits set thus far by State bond issuers through April 1983 have not on average declined measurably from 1982, even though market interest rates and tax-exempt interest rates for mortgages have declined roughly 4 percentage points, which could allow an average decrease in income limits of at least $6,000 and still allow some increase in the price of homes purchased.

Federally imposed purchase price ceilings also did not effectively limit the participation of the more affluent first-time home buyers, because the ceilings were set near the average purchase price of all homes sold in each locality, not those bought by less affluent first-time buyers only.

On average, buyers would have needed an annual income of at least $30,000 in 1982 to buy homes at the price ceiling. Late in 1982, the basis for establishing ceilings was changed by the Congress to allow substantially higher price terms to qualify for mortgage-bond financing. This will put further upward pressure on purchaser incomes.

Despite proponent's arguments to the contrary, mortgage-revenue bonds provide a very inflexible subsidy mechanism. Mortgage revenue bonds cannot provide subsidies in accordance with financial need without additional State or local subsidies.

A direct subsidy, such as a home buyer tax credit, could allow States and localities to provide much deeper subsidies to qualified purchasers with the lowest incomes. A tax credit could be structured to include refundability of the credit for those whose income tax bills were too low to fully utilize a tax credit.

The bond subsidy cannot be structured to be adjusted if the purchaser's income rises or falls in later years. A tax credit could be.

Under bond programs, mortgage rates are set when the bond is issued, while the granting of mortgage loans usually lags behind issuance by several months. As a result, when interest rates are going up the benefit to some home buyers increases, but when interest rates come down the benefit decreases.

In late 1982 and early 1983, for example, many bond issuers could not loan the funds raised when market interest rates came down. In late 1982; many agencies had to call bonds in substantial amounts. Other agencies blended older higher interest rate funds with more recent tax-exempt money.

Either way, the effectiveness of bond programs was reduced. A direct subsidy, in comparison, can function smoothly regardless of fluctuations in interest rates.

Bond programs generally leave the selection of potential home buyers up to the lenders. An alternative, possible with a tax credit, would be for the administering agency to select participants based on need and then refer them to lenders.

In conclusion, providing subsidies directly to households using a grant or carefully structured tax credit would be less costly than providing mortgage revenue bond financing, while providing greater flexibility to State and local governments in providing assistance. Federal purchase price limits and State and local income limits have not effectively targeted loans to those in need of assistance. Therefore, a more direct subsidy mechanism which effectively targeted benefits to households who could not otherwise afford to purchase homes would be much less costly, more equitable, and more effective than the mortgage revenue bonds now being used by States and localities.

This completes my prepared statement, and my colleagues and I will be happy to respond to questions.

[The prepared statement follows:]

Statement of Baltas E. Birkle, Deputy Director for Operations, Resources, Community, and Economic Development Division, U.S. General Accounting Office

Mr. Chairman and Members of the Committee: We appreciate being asked to assist your Committee in considering some of the policy and technical issues surrounding the use of mortgage revenue bonds. As you may know, we are in the final stages of completing a comprehensive study of the costs and benefits of mortgage revenue bonds. Our remarks today, will parallel and expand somewhat upon information provided to the Chairman of the Senate Committee on Finance in a report dated April 18, 1983. That report was written to answer the Chairman's questions regarding:

The extent to which low and moderate income homebuyers have been assisted by mortgage revenue bonds,

The effectiveness of Federal purchase price ceilings and locally imposed income ceilings in targeting program benefits, and

The economic efficiency of mortgage revenue bonds in general.

To answer these questions we analyzed the loan activity of 40 State and local bond issuers that borrowed in the tax-exempt market between December 1981 and July 1982. Our findings are based on more than 20,000 home loans made with these bond proceeds.

In addition, we compared the costs of the bond program to the costs of other subsidy options which could be used to provide the same or similar benefits to homebuyers. We met with housing experts in government, industry, and academia to compile a list of such options and selected two of the more feasible options for comparison—mortgage grants and an annual tax credit to homebuyers. For the mortgage grants and an annual tax credit to homebuyers. For the mortgage revenue bond program and both options, we set assumptions and developed an analytical model which we used to calculate the Federal costs associated with the revenue bond program and the other alternatives. We estimated the lifecycle costs incurred by the Federal government for a typical housing unit rather than limiting our analysis to the yearly costs for a given volume of bonds sold.

Overall, our analysis indicates that mortgage revenue bonds are very costly when compared to the benefits they provide to assisted homebuyers and to the costs of other alternatives which could provide the same level of assistance. We also found that the public purpose objective of subsidizing low- and Moderate-income households who need assistance to purchase homes, is not generally achieved. A major reason for this is that purchase price and income limits have been ineffective in targeting benefits to this group.

In our statement today we take no position on whether or not subsidies should be made available to facilitate low- and moderate-income homeownership. Rather, we note that if Congress wishes to continue to provide such subsidies, there are more economical ways to do so than with mortgage revenue bonds. We also believe it would make sense to limit such subsidies to those first-time homebuyers who could not otherwise buy homes.

BACKGROUND

In the late 1970's as other forms of mortgage finance were adjusting to changes in the regulatory environment for lenders, the revenue bond method of finance was developing. Under this approach, State or local agencies issue tax-exempt bonds whose proceeds are used to provide below market interest rate mortgages to first-time homebuyers. The popularity of mortgage revenue bonds spread rapidly but at the same time their perceived costs to the Federal Government and their possible inequitities aroused substantial congressional opposition. Their rapid growth rate was expected to continue because State and local finance agencies could issue these politically popular revneue bonds at little cost to themselves—the major costs are borne by the Federal Government in the form of lost tax revenue. These factors caused the Congress to begin considering legislation in 1979 which would limit the volume of bonds issued and attempt to confine their use to low- and moderate-income households. Those deliberations resulted in the Mortgage Subsidy Bond Tax Act of 1980 which placed a variety of restrictions on the use of mortgage bonds. As you know, that act also eliminated the use of mortgage revenue bonds as tax-exempt investments after December 31, 1983.

Implicit in the debate and the events leading up to the 1980 act was the Congress' intent that mortgage revenue bonds benefit those low- and moderate-income households who would have difficulty buying homes at conventional mortgage rates. This is also evidenced by the fact that homebuyer income ceilings were proposed, but later dropped under the assumption that purchase price ceilings and a first-time buyer requirement in combination with income limits imposed by most States and local jurisdictions would effectively target that bond proceeds to those needing assistance.

COST EFFECTIVENESS

With regard to the overall economic efficiency of mortgage revenue bonds, we found them to be quite costly to the Federal Government when compared to the benefits provided buyers and to the possible costs of alternative subsidy mechanisms which could be employed. Estimating the costs of mortgage revenue bonds—namely, the Federal tgax losses due to the issuance of tax-exempt bonds—is a controversial subject. As you know GAO is not alone in its finding that these bonds are a costly tool for providing housing subsidies. The Treasury Department, the Congressional Budget Office, the Joint Committee on Taxation, and independent experts have produced a range of estimates over the years showing mortgage bonds to be an inherently inefficient subsidy. State and local bond issuers, on the other hand, have often expressed concern that many of these estimates so simplify reality that they cannot be reliably used as a basis for making judgments about the relative worth of tax-exempt financing. With this in mind, we constructed cost estimates using a wide variety of assumptions. In all our calculations, the costs of mortgage revenue bonds in 1982 were estimated to be substantially greater than the benefits to homebuyers, with cost estimates ranging from about 3 to 6 times the benefits. The major reason for this is that tax-exempt housing bonds provide large tax savings to bond purchasers and profits for many financial and legal intermediaries.

Based on taxable and tax-exempt interest rates existing during 1982, and using what we feel are reasonable assumptions constructed using the advice of other government analysts and Wall Street financial experts, we calculated that the long term revenue loss to the Treasury resulting from the use of tax-exempt bonds could be roughly four times the benefits provided to homebuyers in the form of reduced monthly mortgage payments. Using a tax-credit or a direct grant to lenders, Federal costs could be substantially reduced to a level roughly equal to the cash value of the mortgage interest savings to homebuyers.

We calculate, for example, that the present value of lost tax revenue related to revenue bond loans made in 1982 will average at least $13,300 per loan (Exhibit 1) based on an average mortgage amount of $43,300. The cash value of the subsidy to homebuyers is about $50 per month. By contrast, this benefit could be provided as a $3,400 one-time grant to buy down the conventional mortgage interest rate, or through yearly tax-credits with a present value cost of about $3,500. The approximately $10 billion raised with revenue bonds for home loans in 1981 and 1982 could result in a tax revenue loss of $2.66 billion in present value. A direct subsidy program providing the same number of loans could have been funded for about $680 million—a savings of approximately $2 billion. Even greater savings (or greater benefits) could have been achieved if loans had been granted only to those low- and moderate-income households that needed assistance to purchase homes.

Direct subsidies such as grants or tax-credits would not only reduce overall government costs while maintaining the same benefits to homebuyers but could also improve program equity, enhance targeting, and generally provide more flexibility to State and local governments.

INEQUITY

The structure of the mortgage revenue bond subsidy—normally a fixed interest rate reduction to all buyers—is inherently inequitable. The higher the income of the buyer and the less likely the buyer is to need help, the more they recieve in subsidy and the greater the cost incurred by the Government. This is because higher income buyers generally buy more expensive homes than those with modest incomes. For example, in 1982 we estimate that the average mortgage revenue bond homebuyer received a subsidy equal to about $600 per year which will eventually cost the Treasury about $134,300 in present value. But for a household earning about $20,000 annually, the subsidy was worth $480 per year while a household earning $40,000 received a yearly interest reduction of about $820 (Exhibit 2). The costs incurred to provide the subsidy are also drastically different between income groups. To subsidize the $20,000 income purchaser's home with a mortgage of $34,900 will, over time, cost the Treasury roughly $10,700, while subsidizing the $40,000 income purchaser's home with a $60,000 mortgage will have a present value cost to the Treasury of $18,400.

Using information on incomes and purchase prices, we have constructed a profile of who benefits from mortgage revenue bonds and how this distribution of benefits might be altered using a tax-credit or mortgage grant. Based upon 1982 statistics, we believe that the largest share—74 percent—of the costs of mortgage revenue bonds went to benefit high-income bond purchasers, bond underwriters, lawyers and other intermediaries rather than to homebuyers. Only 26 percent of the cost resulted in benefits to homebuyers. In contrast, providing the same households with the same assistance they received in 1982, but using a more efficient subsidy such as a tax-credit, could have reduced the proportion of subsidy lost to delivery expenses to less than 6 percent leaving 94 percent to benefit homebuyers (Exhibit 3). With lower interest rates in 1983, which will make mortgage revenue bonds somewhat less expensive, we estimated that the proportion of costs going to benefit bond purchasers and intermediaries will still exceed 57 percent (Exhibit 4).

BENEFICIARIES

We found that most subsidized home loans were not made to low- and moderate-income households in need of assistance, but rather to middle-income households who probably could have purchased homes without assistance.

The majority of mortgage revenue bond homebuyers in 1982 were one or two person middle-income households between 20 and 35 years of age (Exhibits 5, 6, 7, 8). In guaging whether or not this group of homebuyers needed assistance or how their incomes compared to the general population, national statistics on purchaser's incomes and median home prices are nearly meaningless. One must rather consider the geographic locations of individual homebuyers and their family sizes. Without considering family size or location, 53 percent of mortgage revenue bond borrowers had incomes above the median in their States (Exhibit 9), but when family size and location within the State are taken into account, 78 percent of all loan recipients were above median income in the local areas in which they resided (Exhibit 10). Using HUD's eligibility requirements for subsidized homeownership assistance, 76 percent of mortgage bond homebuyers could not have qualified for homeownership assistance. And using Congress definition of low- and moderate-income for assisted housing programs, only about 6 percent could have been classified as low and moderate income (Exhibit 11).

AFFORDABILITY

Without stringent income limitations one would expect some mortgage revenue bond homebuyers to (1) buy homes somewhat more expensive than they could have without the subsidy while others would, or (2) buy about what they would have without the subsidy, merely reducing their monthly payments without any significant change in their housing consumption. To explore the latter possibility we determined which of 7,600 mortgage bond homebuyers in seven States had incomes high enough to have qualified for market interest rate mortgage loans in 1982 (Exhibit 12). Applying the same debt to income criteria used by lenders in granting mortgage revenue bond loans, we estimate that 88 percent of the 1982 mortgage revenue bond purchasers could have qualified for loans at a 15.5 percent interest rate which is above the average rate for loans closed by both mortgage bankers and savings and loans associations in 1982 (Exhibit 13).

Using the same interest rate (15.5 percent) and a 28 percent ratio of housing costs to income which would have been more stringent than any standard in wide use during 1982, nearly 50 percent of mortgage revenue bond homebuyers could have purchased the same homes in 1982 without subsidy. Even using a 16.5 percent interest rate which is the highest rate actually experienced in 1982 and the most stringent debt to income ratio, 40 percent of bond assisted purchasers could still have bought the same homes without subsidy. Had most of the remaining households chosen to wait only a few months, or used a graduated payment mortgage which substantially increases affordability, they very likely could also have purchased during 1982 without subsidy (Exhibit 14).

This establishes a range of from at least 40 percent and perhaps as great at 90 percent of 1982 mortgage bond homebuyers who could have purchased the same homes at the same time without assistance. Our best estimate using these and a variety of other measures is that at least 75 percent of revenue bond assisted households could have purchased without assistance in 1982. This is not inconsistent with our findings in a 1978 report on the 1974/75 Federal Emergency Housing Program, which used a subsidy provided directly to lenders (without income limits for purchasers) to reduce the interest rate on loans. That study found that sixty-two percent of the recipients would have purchased a home at the same time even if the lower rate loan had not been available. That program used mortgage limits rather than income targeting. With proper benefit targeting the costs associated with unnecessary loans could largely be eliminated.

INCOME CEILINGS

Effective income and purchase price ceilings could very likely have enhanced the targeting of program benefits under mortgage revenue bonds. But, the shallow interest subsidy provided by bonds and the desire of issuers' to limit risk to bond holders, and quickly place bond proceeds, would still have limited the ability of mortgage revenue bonds to reach those households who could not otherwise have purchased homes without assistance.

In the absence of Federal income guidelines, State and local jurisdictions have generally set their own income ceilings. Some have opted for higher ceilings than others. Most jurisdictions set ceilings allowing the participation of middle- and upper-income households. For example, in 1982, nearly all jurisdictions with bond programs allowed four person households with incomes in the $30,00-$40,000 range to participate in some or all sub-areas within their jurisdiction. Half of the 40 jurisdictions set these income ceilings at or above $40,000 (Exhibit 15). At the extremes, two States and two local bond-issuing jurisdictions set no income limitations for assisted households, while a few set income requirements below $20,000 for a portion of the bond funds.

One contention made by mortgage revenue bond proponents with regard to income levels of buyers in 1982 is that the income ceilings for loans were raised out of necessity in 1981 and 1982 because of the unusually high mortgage interest rates. According to the Council of State Housing Agencies, high interest rates in the bond market during 1981 and 1982 meant that mortgage revenue bond programs had a difficult time reaching their traditional low- and moderate-income constituencies. Thus they conclude that many housing agenices were forced to extend their programs to higher income families than they were typically accustomed to serving.

To examine this, we analyzed information on income ceilings during three periods—pre-1980, 1981–1982, and thus far in 1983 (Exhibits 16, 17, 18). This information leads us to two conclusions:

Although income targeting varies substantially from issuer to issuer, State and local income limits for mortgage revenue bond loans have not been set during any of these periods so as to limit participation to low- and moderate-income households in need of assistance.

Income limits set thus far by State bond issuers through April 1983 have not, on average, declined measurably from 1982 even though market interest rates and tax-exempt interest rates for mortgages have declined roughly 4 percentage points which could allow an average decrease in income limits of at least $6,000 and still allow some increases in the price of homes purchased.

PURCHASE PRICE CEILINGS

Federally imposed purchase price ceilings (Exhibit 19) also did not effectively limit the participation of the more affluent first-time homebuyers because the ceilings were set near the average purchase price of all homes sold in each locality—not those bought by less affluent first-time buyers only. If we average the more than 100 local price ceilings for new and existing homes established for 1982 and assume a 13.75 percent interest rate for subsidized loans in 1982, we can calculate an average minimum income required to buy these highest priced homes. For new and existing homes, buyers would have needed annual incomes of at least $30,000 and $25,000, respectively. Late in 1982, the basis for establishing ceilings was changed by the Congress to allow substantially higher priced homes to qualify for mortgage bond financing. This will put further upward pressure on purchaser incomes and may also help explain why income limits are not in general being lowered.

FLEXIBILITY

Despite proponents' arguments to the contrary, mortgage revenue bonds privide a very inflexibile subsidy mechanism. A number of the characteristics of an effective subsidy mechanism are missing. Mortgage revenue bonds cannot be structured to (1) adjust the subsidy level based on the financial need of loan applicants or changes in homeowners incomes after they purchase their home, (2) function smoothly during periods of fluctuating interest rates and market instability, and (3) select among loan applicants based upon need.

A direct subsidy mechanism such as a tax-credit could be structured to have these desirable characteristics. More specifically,

Mortgage revenue bonds cannot provide subsidies in accordance with financial need without additional State or local subsidies to further write-down the mortgage interest rates. As a result, mortgage bonds are inequitable in that they provide smaller benefits to lower income purchasers (Exhibit 2). A direct subsidy such as a homebuyer tax-credit could allow States and localities to provide much deeper subsidies to qualified purchasers with the lowest incomes and gradually decrease the subsidy for purchasers with less financial need. A tax-credit could be structured to include refundability of the credit for those whose income tax bills were too low to fully utilize a tax-credit.

The bond subsidy, once a loan is made, declines slowly as the mortgage balance is paid off but probably cannot be structured to be adjusted if the purchasers income rises or falls in later years. A tax-credit could be structured to vary with household income. The credit could increase should income fall thereby helping to avoid default or foreclosure and, conversely, the credit could decrease if a purchaser's income increased substantially.

Under bond programs, mortgage rates are set when the bond is issued based on the yield demanded by bond investors. The granting of mortgage loans usually lags behind issuance by several months. As a result, when interest rates are going up, the benefit to some homebuyers increases but when interest rates come down, the benefit decreases. In late 1982 and early 1983, for example, many bond issuers could not loan the funds raised when market interest rates came down lower than the mortgage revenue bond lending rates to homebuyers. In late 1982 and continuing this year many agencies had to call bonds in substantial amounts. Other agencies blended older higher interest rate funds with more recent tax-exempt money raised at lower interest rates. Either way, the effectiveness of bond programs was reduced—tax expenditures were incurred without any mortgage subsidy in the case of calls and in the case of blending, the mortgage subsidy was diluted. A tax-credit, in comparison to bonds, can function smoothly regardless of fluctuations in interest rates.

Bond programs generally leave the selection of potential homebuyers up to the lenders whose main criteria is first-come, first-serve and whether the applicant provides a reasonable underwriting risk. An alternative would be for the administrating agency to select participants based on need and then refer them to lenders and possibly assist them to shop for the best mortgage interest rates. This would also allow potential homebuyers to combine the benefits of lower monthly payments in the earlier years of a graduated payment mortgage with the tax-credit in order to have a greater chance of homeownership.

COUNTERCYCLICAL STIMULUS TO THE ECONOMY

Another argument used by proponents in support of mortgage revenue bonds is that they increase housing production in general and did so in particular during

1982. This would in turn result in job creation and overall increases in incomes and Federal tax revenues. In performing a study which was published last August entitled "Analysis of Options to Aid the Homebuilding and Forest Products Industries", we concluded after analyzing a variety of stimulus proposals including mortgage revenue bonds, that:

Certain direct subsidies such as tax-credit or mortgage grants would increase employment and Federal revenues in the short run, but the costs of such subsidies were greater than the revenue increases;

Greater use of mortgage revenue bonds, however, would have little impact on either housing starts or employment in the short run because, (1) the subsidies were too small to induce additional households to buy in a very high interest rate environment, (2) the bond mechanism was too slow to act quickly when the economy was at its low point, (3) the costs would clearly outweigh the very limited stimulative effect and, (4) tying bonds to new construction could result in much of the subsidy being realized by individual builders.

In conclusion, providing subsidies directly to households using a grant or carefully structured tax-credit would be less costly than providing mortgage revenue bond financing while providing greater flexibility to State and local governments in providing assistance. Federal purchase price limits and State and local income limits have not effectively targeted loans to those in need of assistance. Taken together, these conclusions infer that a more direct subsidy mechanism which effectively targeted benefits to households who could not otherwise afford to purchase homes would be much less costly, more equitable, and more effective than the mortgage revenue bond programs now being used by States and localities.

This completes my prepared statement. My colleagues and I will be happy to respond to any questions.

GENERAL ACCOUNTING OFFICE

EXHIBITS TO ACCOMPANY TESTIMONY
PRESENTED BY BALTAS E. BIRKLE

BEFORE THE

COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

JUNE 15, 1983

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EXHIBIT 1

FEDERAL COST OF PROVIDING THE SAME BENEFIT TO HOMEBUYERS UNDER MORTGAGE REVENUE BONDS AND ALTERNATIVES

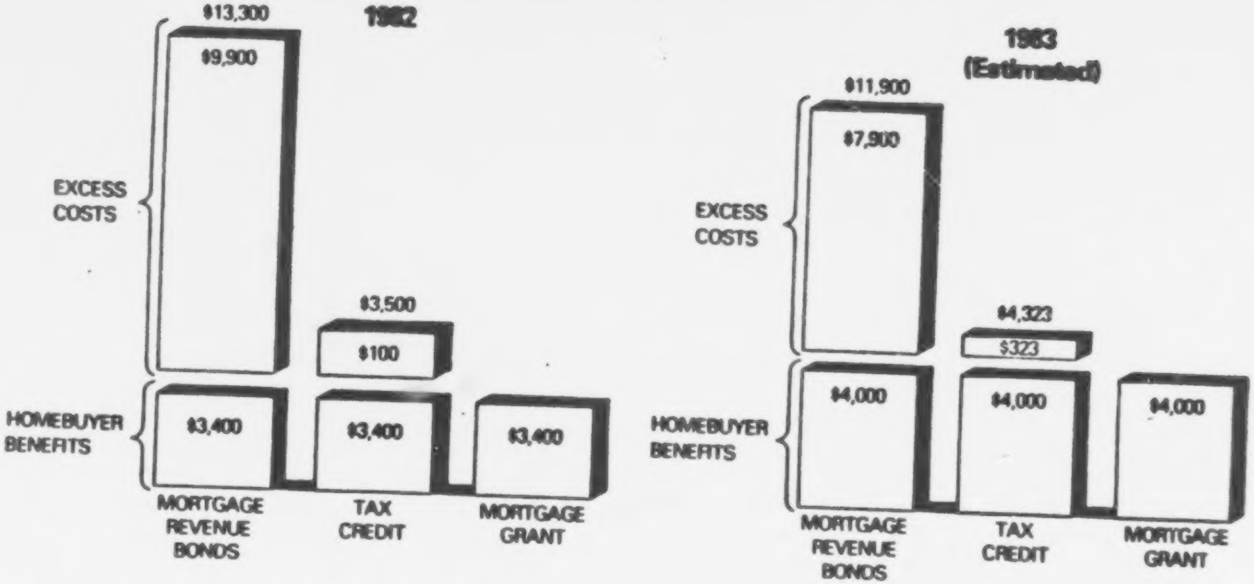


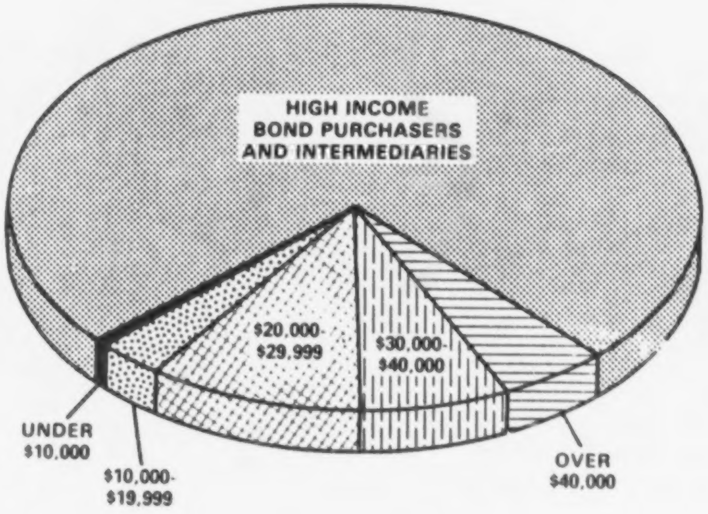
EXHIBIT 2

Average Cost and Subsidy Per MRB Loan By Income Group

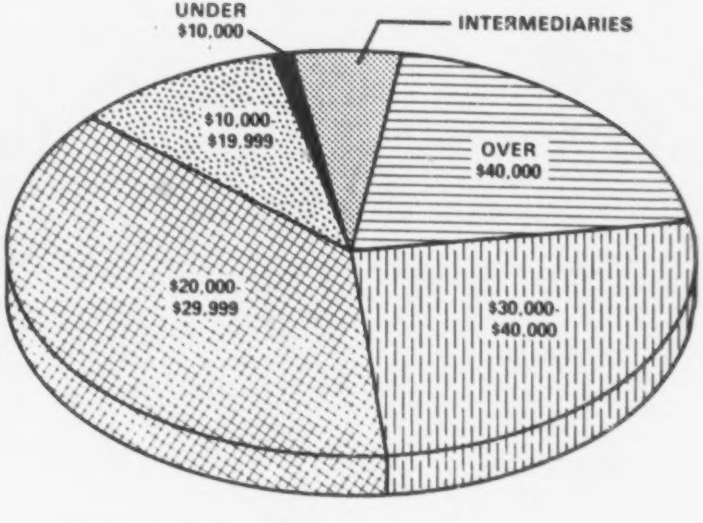
Income group ($000)	Distribution of funds lent (Percent)	Distribution of loans made (Percent)	Average mortgage amount	Average cost per loan	Average monthly MRB subsidy
0-20	10	17	$ 29,089	$ 8,935	33
20-30	40	45	41,865	12,859	48
30-40	28	24	53,401	16,403	61
40-50	15	10	68,046	20,901	78
Over 50	7	4	72,697	22,330	83
Total	100	100			

EXHIBIT 3

INCOMES OF BENEFICIARIES OF MORTGAGE REVENUE BONDS AND ALTERNATIVES



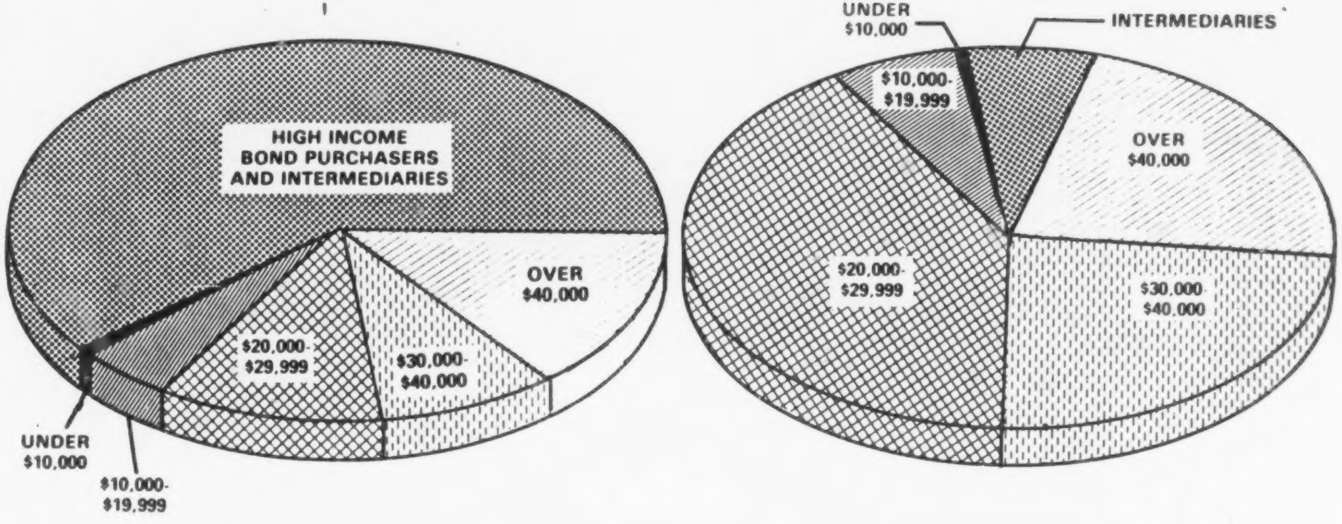
MORTGAGE REVENUE BONDS



TAX CREDIT OR MORTGAGE GRANT

EXHIBIT 4

INCOMES OF BENEFICIARIES OF MORTGAGE REVENUE BONDS AND ALTERNATIVES (PROJECTED 1983)



MORTGAGE REVENUE BONDS

TAX CREDIT OR MORTGAGE GRANT

EXHIBIT 5

Household Size of MRB Borrowers in Eight States

Family Size	Alaska	Connecticut	Idaho	Indiana	Kentucky	New York	Oklahoma	Virginia	Total	Percent of homebuyers
	Number of Borrowers									
1	493	470	78	270	142	219	240	107	2,019	23
2	415	789	116	101	96	906	595	402	3,420	38
3	195	370	73	306	76	276	278	190	1,764	20
4	145	353	52	121	51	185	196	91	1,194	13
5	43	119	27	55	20	37	44	35	340	4
6	8	28	7	14	10	15	12	7	101	0
7	1	10	3	2	0	2	2	1	21	0
Over 8	0	1	2	2	0	0	0	0	5	0
Total	1,300	2,140	358	871	395	1,640	1,367	833	8,904	100

EXHIBIT 6

Age of MRB Homebuyers in Eight States

Age	Alaska	Connecticut	Idaho	Indiana	Kentucky	New York	Oklahoma	Virginia	Total	Percent of homebuyers
	Number of Borrowers									
0-20	32	14	6	42	17	6	53	8	178	2
21-25	368	597	139	307	153	465	520	301	2,850	32
26-30	452	761	118	295	119	645	408	286	3,084	35
31-35	239	419	42	119	64	290	198	136	1,507	17
36-40	96	187	22	47	17	121	84	54	628	7
41-45	51	70	10	20	11	50	49	32	293	3
46-50	20	44	4	15	7	25	16	4	135	1
51-55	17	19	3	15	3	21	14	6	98	1
56-60	13	15	5	2	3	8	15	1	62	1
Over 60	12	14	1	9	1	9	10	5	61	1
Total	1,300	2,140	350 a/	871	395	1,640	1,367	833	8,896	100

a/ Age information on 8 cases was unknown.

EXHIBIT 7

DISTRIBUTION OF MRB HOMEBUYER INCOMES

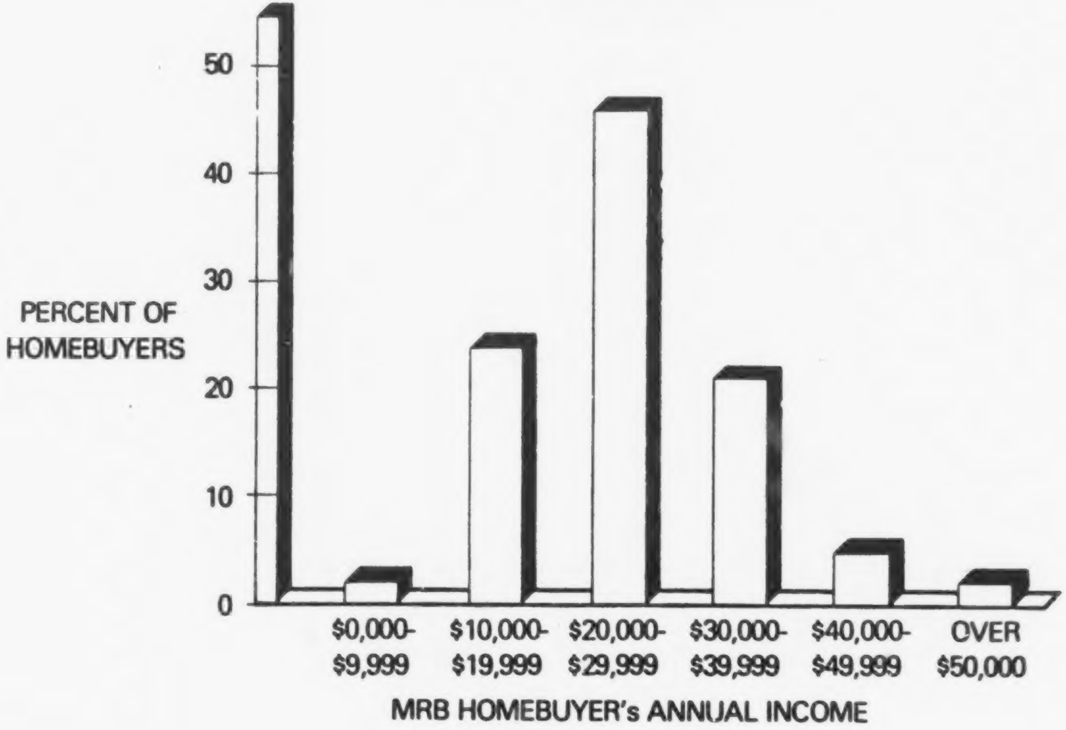


EXHIBIT 8

Income Distribution Of MRB Homebuyers In 40 Jurisdictions

By Bond-Issuing Authority

Number of Participants by Income Level

Jurisdiction	Homebuyer income in thousands						
	0-10	10-20	20-30	30-40	40-50	Over 50	Total
Alaska	0	34	317	407	358	184	1,300
California							
Fairfield City	0	1	36	22	24	10	93
Fresno County	0	16	107	86	4	0	213
Newark City	0	5	29	82	77	59	252
Riverside County	0	2	71	77	3	0	153
Colorado							
Larimer County	1	23	119	3	0	0	146
Connecticut	0	264	1,419	394	53	10	2,140
Florida	6	50	51	2	0	0	109
Broward County	0	30	222	0	0	0	252
Dade County	0	10	125	0	0	0	135
Duval County	0	38	150	54	0	0	242
Hawaii	0	0	19	11	0	0	30
Idaho	0	146	207	5	0	0	358
Indiana	8	266	319	77	5	0	675
Kentucky	3	271	121	0	0	0	395
Louisiana	9	111	469	747	0	0	1,336
Maine	0	14	70	0	0	0	84
Maryland				0	0	0	
Montgomery County	0	42	335	231	0	0	608
Washington County	0	13	50	21	1	0	85
Michigan	0	2	53	17	0	0	72
Minnesota	0	10	27	1	0	0	38
Missouri	6	238	696	24	0	0	964
Montana	0	44	187	16	0	0	247

EXHIBIT 8 (continued)

Jurisdiction	Homebuyer income in thousands						
	0–10	10–20	20–30	30–40	40–50	Over 50	Total
Nebraska	53	250	257	29	0	0	589
New Hampshire	0	1	1	0	0	0	2
New Jersey	0	11	46	37	19	3	116
New York	6	124	555	557	286	112	1,640
North Carolina	6	220	199	0	0	0	425
Oklahoma	1	96	373	499	178	84	1,231
Pennsylvania	105	597	877	271	0	0	1,850
Rhode Island	58	929	617	105	3	0	1,712
South Dakota	0	7	26	6	0	0	39
Tennessee	134	790	274	0	0	0	1,198
Texas							
East Texas	0	0	4	0	0	0	4
Gregg County	0	5	24	15	3	0	47
Tarrant County	16	34	42	8	0	0	100
Utah	13	76	107	66	0	0	262
Virginia	0	2	21	2	0	0	25
Wyoming	0	161	577	95	0	0	833
	0	20	117	239	95	0	471
Total participants	425	4,953	9,316	4,206	1,109	462	20,471
Percent of participants	2	24	46	21	5	2	100

EXHIBIT 9

MRB Homebuyers With Income Above State Family Median Income In 40 Jurisdictions

Jurisdiction	State median income	Number of homebuyers above median	Percent of homebuyers above median
Alaska	$ 31,608	887	68
California	26,721		
Fairfield		71	76
Fresno		132	62
Newark		237	94
Riverside		113	74
Colorado	24,813		
Larimer		70	48
Connecticut	30,801	338	16
Florida	20,231	53	49
Broward		222	88
Dade		125	93
Duval		204	84
Hawaii	29,167	13	43
Idaho	21,729	144	40
Indiana	24,001	235	35
Kentucky	18,682	185	47
Louisiana	18,700	1,216	91
Maine	21,140	66	79
Maryland	28,255		
Montgomery		308	51
Washington		31	36
Michigan	27,236	48	67
Minnesota	24,097	19	50
Missouri	21,639	585	61
Montana	21,398	178	72
Nebraska	21,453	207	35
New Hampshire	24,549	1	50
New Jersey	30,199	59	51
New York	27,789	1,092	67
North Carolina	19,862	199	47
Oklahoma	19,647	1,134	92
Pennsylvania	24,892	673	36
Rhode Island	24,381	307	18
South Dakota	18,635	33	85
Tennessee	18,770	350	29
Texas	21,724	3	75
East Texas		38	81
Gregg County		39	39
Tarrant		152	58
Utah	23,800	14	56
Virginia	23,043	479	58
Wyoming	24,182	419	89
		10,679	53

EXHIBIT 10

Income Distribution of MRB homebuyers in Eight States as a Percent of State Family Median Income

Income group as a percent of State family median income	Percent of Homebuyers: Before adjusting for family size	Percent of Homebuyers: After adjusting for family size
0- 50 (low income)	1	0
50- 80 (moderate income)	18	7
80-100 (middle income)	28	15
100-120 (middle income)	24	24
120-200 (higher income)	26	45
Over 200	3	9
Total	100	100

EXHIBIT 11

MRB Borrowers Who Could Qualify for HUD Housing Subsidy Programs In Eight States

	Section 8 a/				Section 235 b/	
State	50% of median		80% of median		95% of median	
(Total Loans)	Number	Percent	Number	Percent	Number	Percent
Alaska (1300)	0	0	3	0	190	15
Connecticut(2140)	5	0	151	7	630	29
Idaho (358)	2	1	34	9	119	33
Indiana (871)	7	1	157	18	374	43
Kentucky (395)	3	1	50	13	338	86
New York (1640)	6	0	68	4	274	17
Oklahoma (1367)	2	0	27	2	71	5
Virginia(833)	1	0	26	3	128	15
Total (8904)	26	0	516	6	2124	24

a/Under Section 8 Rental Assistance payments, HUD pays the difference between fair market rents and the tenant's contribution. Low- and moderate-income families are eligible, defined as earning no more than 80 percent of the area median income, adjusted for family size and certain other factors. The Housing and Community Development Amendments of 1981 required that very-low-income people be given preference for Section 8 subsidies, defined as families earning no more than 50 percent of the area median income.

b/Under Section 235 Homeownership Assistance for Low-and Moderate-Income Families, HUD insures loans to make homeownership available to families with incomes under 95 percent of area median family income. Also, under this program, HUD subsidizes the homeowner's interest rate to as low as 4 percent. The Section 235 income ceilings include hundreds of exceptions which generally raise the ceilings above the 95 percent of median standard.

EXHIBIT 12

Methodology used to determine if MRB homebuyers could have purchased their homes without subsidy

Our methodology is based on data provided on 7,604 MRB homebuyers in seven states (Connecticut, Idaho, Indiana, Kentucky, New York, Oklahoma and Virginia). We excluded the eighth state--Alaska--where we had details on each individual MRB homebuyer because interest rates charged homebuyers are subsidized by the State down to about 10 percent. The data based on the seven states includes the following information on each homebuyer: homebuyer annual income, purchase price, mortgage amount and interest rate. Using this data, we performed the following analysis:

--For each of the 7,604 homebuyers, we calculated the percent of annual income which lenders allowed for housing costs. Housing costs included principal and interest at the mortgage interest rate charged the homebuyer plus real estate taxes, and hazard and mortgage insurance. From these percentages, we determined the criteria lenders used to qualify (approve) homebuyer mortgage loans.

--Next we determined what housing costs would have been for each of the 7,604 buyers including principal and interest on their loan at a conventional mortgage interest rate of 15.5 percent and real estate taxes, and hazard and mortgage insurance.

--We then determined the percent of income which would have been used to pay housing costs at the conventional interest rate for each of the 7,604 homebuyers.

--As a final step, we determined which of the 7,604 homebuyers needed the MRB subsidy by comparing the criteria used by lenders to approve MRB loans with the percent of income which would have been used to pay housing costs at conventional interest rates. If the percentage of homebuyer income fell below the lenders criteria, we concluded that the homebuyer could have purchased in 1982 using a conventional or unsubsidized FHA mortgage.

EXHIBIT 13

MRB Homebuyers In Seven States Who Could Have Purchased In 1982 Without Subsidy Using a 15.5 Percent Loan

	Percent of homebuyers a/	Percent of homebuyers b/	Percent of homebuyers c/
Connecticut	87	63	28
Idaho	82	54	28
Indiana	90	80	60
Kentucky	87	77	48
New York	91	93	72
Oklahoma	92	92	67
Virginia	77	53	17
Weighted Average	88	76	48

a/ Based on housing costs to income standards that lenders actually used in approving MRB loans. Using this criteria assumes that lenders did not apply more lenient loan qualification standards to MRB homebuyers than to homebuyers who obtained market rate loans.

b/ Based upon a housing cost to income standard of 33 percent which is a reasonable proxy for the standard used for conventionally insured and government insured loans granted in 1982. Conventionals would routinely have been granted at 30 percent with many exceptions possible for smaller households and FHA and VA loans would have generally allowed much higher debt to income ratios given their methodology for qualifying buyers.

c/ Based on the most stringent standard used for market rate loans during 1982. Using this standard assumes that lenders applied a much stricter standard for market rate loans than for MRB loans.

EXHIBIT 14

INCREASE IN AFFORDABILITY WITH AND WITHOUT SUBSIDY DURING 1982 FOR THREE INCOME LEVELS

HOMEBUYER ANNUAL INCOME	15,000	22,500	30,000
MONTHLY MORTGAGE PAYMENT BUYER CAN AFFORD	312	468	625

INCREASED HOME PRICES BUYERS COULD AFFORD IN 1982 WITH:

STANDARD MORTGAGE (15.5%) (NO SUBSIDY)	25,260	37,890	50,400
MRB LOAN (13.75%) (NO SUBSIDY) OR EQUIVALENT TAX CREDIT	28,200	42,300	56,400
GRADUATED PAYMENT MORTGAGE (15.5%) (NO SUBSIDY)	29,600	44,400	59,300

EXHIBIT 15

State Or Locally Imposed Income Limits For MRB Homebuyers, Ranked By Percent Of Family Median Income For A Family Of Four

(Includes all States that issued bonds
during 1981 and 1982)

State	As a percent of HUD's State Family Median Income	Dollar Amount
Oregon	106	$26,000
Michigan	116	31,750 a/
Maryland	117	33,000 b/
North Carolina	118 (98)	23,500 (19,500) c/
Hawaii	126	36,873 d/
Maine	128	27,000
Colorado	129	32,000 e/
Missouri	129	28,000 f/
Rhode Island	133	32,500
Nevada	133	33,875 (23,750) g/
Wisconsin	139 (96)	34,000 (23,325) h/
Utah	143	34,000 i/
Minnesota	143 (106)	34,500 (25,500) j/
Delaware	144	37,500
Montana	147	31,500 k/
Indiana	148 (68)	35,500 (16,400) l/
Vermont	149	32,500
Kentucky	150 (136)	28,000 (25,500) m/
Nebraska	151	32,500
Pennsylvania	151 (141)	37,500 (35,000) n/
Idaho	152	33,000 o/
Iowa	153 (115)	34,300 (25,800) p/
Massachusetts	155	43,000 q/
Illinois	158	43,000
Tennessee	160	30,000 r/
South Carolina	163	32,200 s/
New Hampshire	163 (113)	40,000 (27,000) t/
North Dakota	165	33,000 u/
New Mexico	167	33,000 v/
Virginia	169 (95)	38,900 (22,000) w/
Texas	175	38,000 x/
Florida	175 (151)	35,400 (30,500) y/
Georgia	183 (131)	37,500 (26,900) z/
South Dakota	185	34,500 aa/

EXHIBIT 15 EXHIBIT 15

State	As a percent of State Family Median Income	Dollar Amount
West Virginia	186	32,700
Wyoming	186	45,000 bb/
California	188 (105)	50,250 (28,000) cc/
Louisiana	214	40,000
Arkansas	224	36,000 dd/
Alabama	227	42,000 ee/
Oklahoma	252 (196)	49,500 (38,500) ff/
Mississippi	255	39,000 gg/
Arizona	261	59,977 (27,589) hh/
Connecticut	Unlimited (87)	Unlimited (26,700) ii/
New Jersey	Unlimited (139)	Unlimited (41,900) jj/
Alaska	Unlimited	Unlimited
New York	Unlimited	Unlimited

City and County	As a percent of SMSA Family Median Income	Dollar Amount
Montgomery County, MD	108	$34,900 kk/
Larimer County, CO	126	30,000
Washington County, MD	126	40,900 ll/
Broward County, FL	130	30,680
Dade County, FL	150	34,800 mm/
Duval County, FL	152	32,600
Fresno County, CA	152 (101)	32,600 (21,800) nn/
Tarrant County, TX	158	40,000
Gregg County, TX	191	37,500
Riverside, CA	194	43,005
East Texas, TX	230	45,000
Newark, CA	Unlimited (120)	Unlimited (36,600) oo/
Fairfield, CA	Unlimited (150)	Unlimited (37,500) pp/

Kansas, Ohio and Washington did not issue tax exempt bonds for single-family housing in 1981 and 1982.

NOTE: Except as otherwise noted, we first determined the dollar amount of State or locally imposed income limits for a family of four from either the Bond Official Statement or directly from bond agency officials. We then compared the dollar limit to the 1981 State family median income (for State bonds) or to the 1981 SMSA/county family median income (for city and county bonds) as determined by HUD for a family of four. Parenthetical percentages represent lower percentages where income limits varied by location, new or existing construction, or targeting part of funds to lower income people.

EXHIBIT 15 EXHIBIT 15

FOOTNOTES

a/Michigan--Overtime earnings of up to $4,000 are excludable in meeting the income limit criteria.

b/Maryland--The income limit applies to two or more persons. The limit for a single person is $28,000.

c/North Carolina--Income limits differ between urban and rural areas and vary by family size. An adjustment of $500 is allowed for each member greater than four. Limits for a single individual range from $14,625 to $17,625. Net assets may not exceed $15,000, except persons between ages 62 and 64 may have net assets of up to $40,000, persons aged 65 may have $50,000, and handicapped persons may have $65,000.

d/Hawaii--Income limits are graduated from 1 to 8 or more household members. Limits for one and two members are $24,582 and $34,373, respectively. An amount of $1,250 is added for each member greater than two but not to exceed $41,873. Borrowers may not have assets (less liabilities secured by such assets and less 25 percent of the downpayment made to purchase the subject property) exceeding the maximum allowable adjusted gross income for a family of the same size.

e/Colorado--Income limit is $23,000 before taxes and withholdings and after deducting (a) a maximum of $12,000 ($3,000 for a co-mortgagor (spouse) and each dependent, except the spouse, and support payments not to exceed $3,000, for other minor children not residing with the household), (b) income from social security or pension for a person who is 62 years old or older or handicapped, (c) amounts equal to all household income considered unusual, temporary or non-related to household members regular employment. Also, a borrower's net worth, exclusive of downpayment and closing costs, may not exceed $35,000.

f/Missouri--Income limits of $28,000 applies to a family of one to four. The limit for a family of five to eight is $32,000.

g/Nevada--Income limit for one member household is $23,750, $27,125 for two, $30,500 for three, $36,625 for five, and $39,250 for six or more.

h/Wisconsin--Income limits are 125 percent of county median income.

i/Utah--Add $500 for each member greater than four and deduct $1,000 for each member less than four.

j/Minnesota--Limits range from $29,500 to $34,500 for new construction and from $25,500 to $29,500 for existing housing depending on geographic location.

k/Montana--Add/deduct $1,000 to the limit for each dependent greater/less than four.

l/Indiana--The income limits apply to 60 percent of mortgage loans and range from $25,600 to $35,500. Limits for the other 40 percent range from $16,400 to $22,720, which represent 80 percent of the median for the borrower's geographic area.

m/Kentucky--Income limits vary by area/location. Add/deduct $1,500 for each member greater/less than four.

n/Pennsylvania--Limits vary by geographic area.

o/Idaho--Add/deduct $1,500 for each member greater/less than four.

p/Iowa--Add/deduct $300.00 for each dependent family member greater/less than residing in household under 18, or over 18 with no income. Income may be increased by 10 percent for households having combined incomes. Additionally, the limits may be increased; by $300 if the head of household has secondary income, unusual income, or extraordinary medical costs.

q/Massachusetts--Add/deduct $1,500 for each dependent greater/less than four.

r/Tennessee--Income limits for 1, 2, 3, and 4 or more member households are $19,000, $24,000, $28,000, and $30,000, respectively.

s/South Carolina--Add/deduct $800 for each member greater/less than four.

t/New Hampshire--The income limits are six times the annual housing costs (principal, interest, and taxes) or $40,000 whichever is lower.

u/North Dakota--The limit applies to families of one to four members. Add $1,000 for each member greater than four.

v/New Mexico--Add/deduct $1,500 for each member greater/less than four.

w/Virginia--Income limits vary between newly constructed and existing dwellings, and by geographic location and family size. Adjustments for family size are $1,000 for the borrower, $2,500 for a working spouse ($1,000 if not working), and $1,000 for each dependent.

x/Texas--The income limit of $38,000 applies to a family unit. The limit for an individual borrower is $30,000.

y/Florida--The income limit can be the greater of 150 percent of county or state median family income. The income limit of $30,500 applies to counties using the State median family income limit.

z/Georgia--Income limits vary between newly constructed and existing dwellings, and by geographic location. Limits range from $32,500 to $37,500 for newly constructed units and $26,900 to $31,000 for existing dwellings. The authority may increase the income limit by as much as 10 percent in identified high housing cost areas.

aa/South Dakota--Add/deduct $1,000 for each member greater/less than four.

bb/Wyoming--The Housing Authority may waive the income limitation.

cc/California--Income limits vary by family size and geographic location. Income limit for a family of one range from $22,400-$39,900 and $25,200-$45,000 for two to three family members. For a family of four or more, limits range from $28,000 to $50,250.

dd/Arkansas--Add/deduct $2,000 for each member greater/less than four.

ee/Alabama--Add/deduct $1,000 for each dependent greater/less than four occupying the home.

ff/Oklahoma--For targeted areas, limits were $49,500, $47,300, and $46,650 in the Tulsa SMSA, Oklahoma SMSA, and other areas, respectively. Limits for non-targeted areas were $45,000, $43,000, and $38,500. Except for the head of household, $1,000 may be added or subtracted for members greater or less than four. Earnings of household members under 18 years old or handicapped are excluded in income determination. Also, a credit of $2,500 is excludable for wage earners over 18, other than the spouse or head of household. Other credits include unusual or temporary income and medical expenses not covered by insurance that is in excess of 3 percent of total adjusted gross income.

gg/Mississippi--Add/deduct $1,000 for each exemption greater/less than four.

hh/Arizona--The higher limit applies to target areas and the lower limit to non-target areas.

ii/Connecticut--The income limit varies by location and family size. Limits range from $24,000 to $30,500 for three or less members and $31,700 to $40,200 for seven or more. Loans in eligible areas may be made without regard to an income but two financial institutions must have refused the loan on its regular interest rate, loan term, and downpayment requirements.

jj New Jersey--There is no income limit for target areas.

kk Montgomery County, Maryland--Income limits for one, two, three, and five or more person households are $27,000, $32,900, $33,900, and $35,900, respectively.

ll Washington County, Maryland--Income limits for one, two, and three person households are $36,900, $38,900, and $39,900, respectively. Add $1,000 to $40,900 for each member greater than four.

mm Dade County, Florida--Income limits for five, six, and seven or more are $36,000, $37,200, and $38,400, respectively.

nn Fresno, California--The income limit of $32,600 applies only to new construction. One-half of funds reserved for existing units has an income limit of $27,200 and the limit for the other half is $21,800.

oo Newark, California--An income limit of $36,600 applies only to 7 percent of loans. There is no limit for 93 percent of loans because they were reserved for the agency's redevelopment areas.

pp Fairfield, California--Income limit of $37,500 applies only to purchases made outside the agency's redevelopment project area. Income limits for one and two/three member households are $30,000, and $33,750 respectively. There are no income limits in redevelopment areas.

EXHIBIT 16

Comparison of MRB Income Ceilings Pre-and Post-Mortgage Subsidy Bond Tax Act of 1980 as a Percent of Family Median Income for a Family of Four

Income Category	Percent Range	State Income Ceilings as a Percent of State Family Median Income		Local Jurisdictions Income Ceilings as a Percent of SMSA Family Median Income	
		June 1978-Sept. 1980 Number	1981-1982 Number	June 1978-Sept. 1980 Number	1981-1982 Number
low and moderate	0-80	0	0	0	0
middle	80-100	7	0	1	0
middle	100-120	5	5	5	1
higher	120-150	6	5	1	0
	150-200	1	9	13	1
	Over 200	2	0	21	0
	No limit	2	4 a/	9	0
Total		23	23	50	2

a/Includes two States that had income limits for some areas.

NOTE: Some jurisdictions had multiple income limits. For simplicity, this analysis compares the highs of these income ceilings ranges.

EXHIBIT 17

MRB Income Ceilings During 1981/82 As a Percent of Family Median Income For a Family of Four

Income Category	Percent Range	Number of Jurisdictions		State & Local Combined
		State Income Ceilings as a Percent of State Family Median Income	Local Jurisdictions Income Ceilings as a Percent of SMSA Family Median Income	
low and moderate	0-80	0	0	0
middle	81-100	0	0	0
middle	101-120	4	1	5
higher	121-150	14	4	18
	150-200	19	5	24
	Over 200	6	1	7
	No limit	4	2	6
Total		47	13	60

NOTE: Some jurisdictions had multiple income limits. For simplicity, this analysis compares the highs of these income ceiling ranges.

EXHIBIT 18

Estimate of How Far Income Ceilings Could Have Been Lowered In 1983 Based on the Decline in Mortgage Interest Rates

Time period	Interest rate	Income required to afford the average MRB mortgage of $43,300
Late 1981	13.75	$ 24,215
Early 1983	9.75	17,865
Ceilings could have dropped by		$ 6,359

Comparison Of State Income Ceilings In 1981/1982 And 1983

Jurisdictions	1981/1982	1983	Increase or (decrease) in 1983
Arkansas	$ 36,000	$ 46,000	$ 10,000
Hawaii	36,873	36,873	-0-
Idaho	33,000	33,000	-0-
Maine	27,000	24,000	(3,000)
Missouri	28,000	31,000	3,000
Montana	31,500	38,500	7,000
Oklahoma	49,500	49,500	-0-
Rhode Island	32,500	42,500	10,000
South Dakota	34,500	30,300	(4,200)
Utah	34,000	34,000	-0-
Average	$ 34,287	$ 36,567	$ 2,280

EXHIBIT 19

Federal Purchase Price Limits For MRB Single-Family Homes In Non-Target Areas

	1982		1983	
AREA	NEW	EXISTING	NEW	EXISTING
Alabama	$ 58,230	$ 50,490	$ 73,150	$ 57,970
Alaska	90,630	74,610	129,140	100,320
Arizona				
Phoenix	80,190	71,820	118,360	92,620
Tucson	74,880	59,670	92,840	74,140
Other	68,670	55,260	54,010	47,410
Arkansas				
Little Rock	55,890	55,260	a/	a/
Other	57,960	52,650	73,150	65,670
California				
Anaheim	104,760	110,430	150,040	124,850
Bakersfield	79,200	59,580	97,900	70,290
Fresno	81,540	52,020	106,260	64,790
Los Angeles	96,390	90,540	124,410	115,610
Oxnar-Simi Valley	97,740	86,580	132,890	116,820
Riverside	80,370	74,070	89,650	94,710
Sacramento	87,030	84,060	94,710	100,760
San Diego	96,930	88,200	115,060	100,210
San Francisco	114,210	96,660	149,380	119,790
San Jose	110,070	129,600	154,740	135,850
Santa Barbara	119,520	98,640	139,590	120,010
San Rosa	88,830	84,870	107,360	109,320
Stockton	60,030	55,980	71,500	65,340
Vallejo	83,520	75,960	102,740	91,410
Other	73,530	80,100	99,110	92,950
Colorado				
Denver	72,000	63,180	76,230	93,940
Other	70,650	49,410	89,540	62,920
Connecticut				
Bridgeport	66,330	75,600	82,830	97,570
Danbury	82,170	70,290	101,860	96,800
Hartford	75,420	59,580	99,330	72,710
New Haven	67,230	55,980	79,200	71,610
Norwalk	107,820	109,440	168,190	137,390
Stanford	127,800	128,340	163,350	164,120
Other	76,680	53,820	99,990	73,370
Delaware				
Wilmington	a/	a/	a/	a/
Other	67,680	52,290	60,060	58,410
Florida				
Daytona Beach	49,950	43,380	66,880	48,290
Fort Lauderdale	62,550	63,270	95,700	86,570

EXHIBIT 19

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AREA	1982		1983	
	NEW	EXISTING	NEW	EXISTING
Fort Myers	$ 65,700	$ 56,610	$ 92,180	$ 106,590
Lakeland	54,900	34,560	70,730	48,510
Miami	72,270	65,250	97,680	92,510
Orlando	55,890	43,200	76,120	54,670
Sarasota	61,110	62,640	94,380	75,130
Tampa	64,890	47,430	83,820	65,340
West Palm Beach	54,810	61,380	93,720	94,600
Other	59,580	45,180	76,450	63,140
Georgia				
Atlanta	79,920	60,300	98,120	73,100
Other	53,370	42,210	67,760	53,240
Hawaii	a/	a/	139,700	121,000
Honolulu	105,300	98,910	a/	a/
Other	136,980	101,520	140,470	121,000
Idaho	70,650	60,390	100,430	81,840
Illinois				
Chicago	73,890	64,170	97,240	82,390
Other	66,060	39,060	78,540	52,800
Indiana				
Indianapolis	77,040	44,910	87,230	61,600
Other	50,850	41,490	68,860	39,380
Iowa	63,810	46,440	61,050	52,250
Kansas				
Wichita	64,710	45,540	73,700	86,020
Other	48,960	37,440	70,400	52,250
Kentucky				
Louisville	64,890	45,180	92,950	56,430
Other	52,560	39,870	72,490	54,560
Louisiana				
New Orleans	83,700	67,320	101,530	82,280
Other	69,210	50,580	81,290	63,360
Maine	66,150	52,380	61,600	59,620
Maryland				
Baltimore	76,050	52,830	85,800	83,930
Other	49,500	50,850	57,090	72,160
Massacusetts				
Boston	71,370	74,690	86,790	77,660
Other	58,230	48,780	71,170	56,430
Michigan				
Detroit	89,370	50,580	121,550	66,110
Other	69,750	40,500	80,410	56,980
Minnesota				
Minneapolis	83,880	61,920	103,070	81,620
Other	63,810	51,210	77,990	62,590
Mississippi	59,130	42,390	67,980	48,070
Missouri				
Kansas City	69,570	46,260	96,910	71,170
St. Louis	74,520	44,370	86,240	70,840

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	1982		1983	
AREA	NEW	EXISTING	NEW	EXISTING
Other	$ 52,920	$ 42,390	$ 63,030	$ 49,390
Montana	71,370	56,070	70,950	66,880
Nebraska				
Lincoln	56,250	46,170	71,720	55,220
Other	45,630	36,000	57,090	45,980
Nevada	88,200	85,050	98,010	94,490
New Hampshire	56,070	48,960	62,700	63,690
New Jersey				
Long Branch	76,140	75,870	85,140	91,960
Newark	97,110	78,840	125,620	103,620
Other	69,750	63,900	86,680	74,360
New Mexico	58,410	41,760	91,960	57,530
New York				
Albany	61,920	42,930	78,430	51,480
Buffalo	63,000	44,730	82,500	51,260
Nassau	82,080	60,300	132,000	83,380
New York City	84,240	71,460	119,680	92,950
Rochester	63,450	42,390	76,340	56,540
Other	58,950	37,620	68,860	40,370
North Carolina				
Charlotte	69,750	53,370	81,400	69,190
Greensboro	79,920	41,220	84,480	51,370
Raleigh	66,150	43,920	87,340	47,630
Other	40,320	38,880	72,270	45,430
North Dakota	71,370	56,070	70,950	66,880
Ohio				
Cincinnati	68,850	52,740	92,400	56,980
Cleveland	77,580	53,640	117,370	71,280
Columbus	69,120	52,020	135,300	65,890
Dayton	76,140	39,960	103,070	49,280
Other	56,340	41,310	84,700	57,860
Oklahoma				
Oklahoma City	71,820	59,940	88,990	74,470
Tulsa	86,040	58,050	99,990	79,860
Other	60,840	41,580	88,110	60,720
Oregon				
Portland	68,850	55,620	99,660	80,520
Other	59,040	47,160	87,010	66,330
Pennsylvania				
Allentown	66,960	43,380	72,710	54,120
Harrisburgh	42,100	42,100	62,590	51,810
Northeast Counties	52,470	29,970	61,820	40,040
Philadelphia	63,270	46,890	86,570	59,950
Pittsburgh	69,390	52,020	99,660	60,500
Reading	63,090	36,810	75,240	44,000
Other	50,940	44,190	56,980	50,820

EXHIBIT 19 EXHIBIT 19

AREA	1982		1983	
	NEW	EXISTING	NEW	EXISTING
Rhode Island				
Providence	$ 64,620	$ 46,260	$ a/	$ a/
Other	66,150	52,380	76,890	53,130
South Carolina				
Columbia	72,450	58,050	88,440	73,700
Greenville	47,700	44,640	73,920	67,650
Other	61,470	48,510	80,960	56,870
South Dakota	71,370	56,070	70,950	66,880
Tennessee				
Chattanooga	53,100	54,270	74,800	62,590
Memphis	73,800	55,800	85,910	76,340
Nashville	60,030	56,610	74,030	62,810
Other	43,020	40,590	71,720	56,870
Texas				
Austin	70,200	63,720	95,370	81,180
Dallas	100,260	64,260	112,420	105,820
Houston	70,560	77,580	89,650	104,830
San Antonio	75,690	64,440	87,560	84,590
Other	57,780	45,450	80,410	55,990
Utah				
Salt Lake City	68,940	48,870	81,620	55,550
Other	82,530	49,410	68,090	60,610
Vermont	52,560	43,110	61,600	59,620
Virginia				
Norfolk	76,950	54,630	95,920	59,730
Richmond	60,750	54,360	77,220	58,410
Other	64,350	44,820	62,700	59,180
Washington				
Seattle	68,760	68,850	96,800	89,210
Other	65,340	51,660	85,030	62,810
West Virginia	50,400	45,810	61,600	55,990
Wisconsin	63,270	49,680	77,110	56,320
Wyoming	71,370	56,070	70,950	66,800
District of Columbia	90,090	83,880	120,010	112,090

a/Not specified

EXHIBIT 20
Percent of Downpayment For MRB Homebuyers In Eight States

Percent of Down Payment	Percent									Number of homebuyers
	Alaska	Connecticut	Idaho	Indiana	Kentucky	New York	Oklahoma	Virginia	Total	
0 - 9	88	46	1	42	71	2	66	88	50	4,447
10 - 19	7	27	91	27	23	58	20	8	29	2,598
20 - 29	3	15	5	17	6	24	9	3	12	1,102
30 - 39	1	7	2	6	0	8	3	1	5	394
40 - 49	*	3	1	4	0	4	1	0	2	204
50+	*	2	0	4	0	4	1	0	2	159
TOTAL	100	100	100	100	100	100	100	100	100	8,904

EXHIBIT 21
Amount of Downpayment By MRB Homebuyers In Eight States

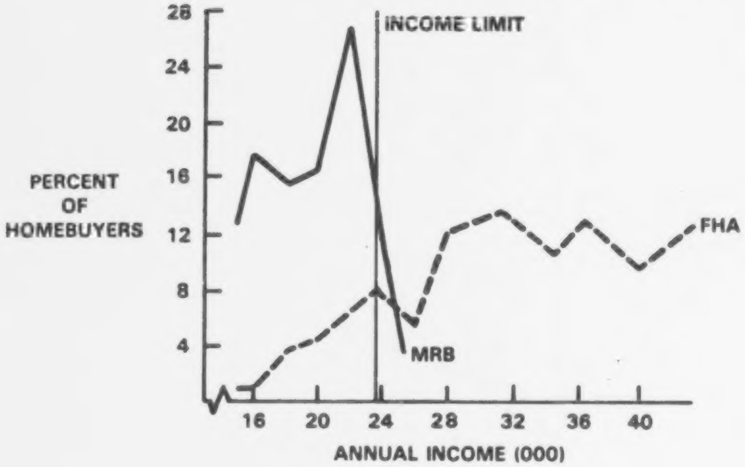
Down Payment Amount	Percent									Number of homebuyers
	Alaska	Connecticut	Idaho	Indiana	Kentucky	New York	Oklahoma	Virginia	Total	
0- 5,000	69	51	70	69	89	39	71	90	63	5,571
5,001- 10,000	23	23	25	17	10	28	15	6	20	1,801
10,001- 15,000	3	11	3	8	1	13	6	3	8	685
15,001- 20,000	2	7	1	3	-	10	3	1	4	395
20,001- 25,000	1	4	1	2	-	4	2	*	2	203
25,001- 30,000	1	2	*	1	-	2	1	-	1	100
30,001- 35,000	1	1	*	*	-	2	1	-	1	70
35,001- 40,000	*	1	-	*	-	1	*	-	*	30
40,001- 45,000	*	*	-	*	-	1	1	-	*	21
45,001- 50,000	*	*	-	-	-	*	*	-	*	10
50,001- 75,000	*	*	-	-	-	*	*	-	*	17
75,001-100,000	-	-	-	-	-	-	-	-	-	1
100,000+										
TOTAL	100	100	100	100	100	100	100	100	100	8,904

* Less than 1/2 percent

EXHIBIT 22

EFFECT OF RESTRICTIVE INCOME CEILINGS ON THE SELECTION OF MRB HOMEBUYERS

NORTH CAROLINA



MAINE

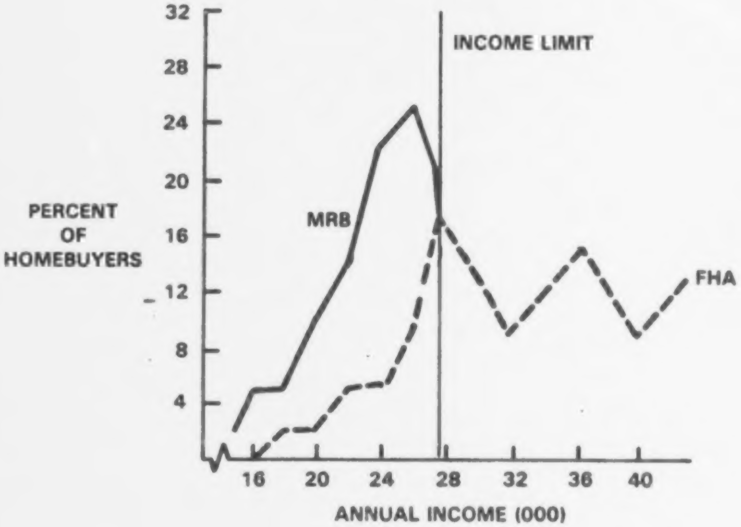
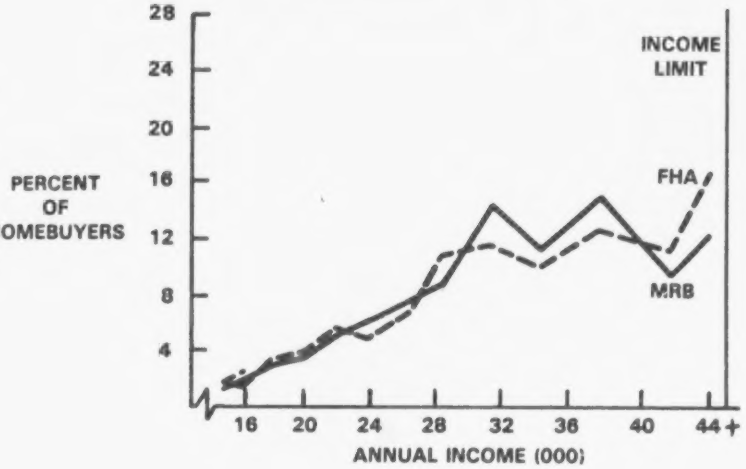


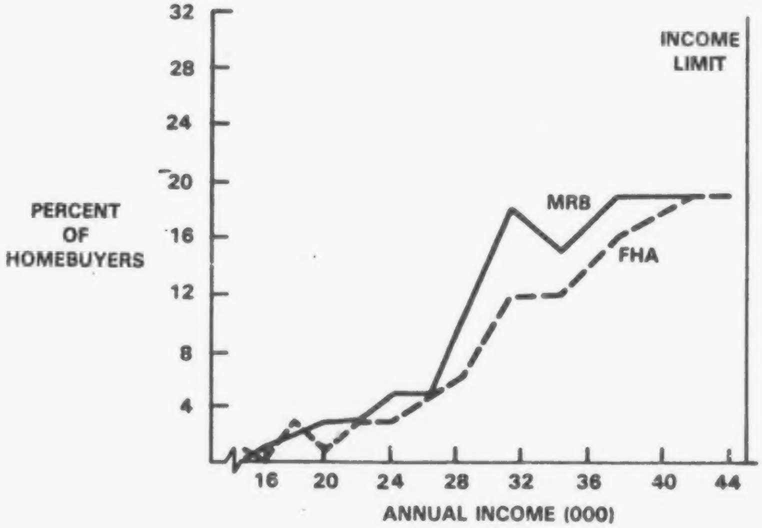
EXHIBIT 23

EFFECT OF NON-RESTRICTIVE INCOME CEILINGS ON THE SELECTION OF MRB HOMEBUYERS

OKLAHOMA



WYOMING



Mr. PICKLE. Mr. Birkle, we thank you for your testimony.

Now, I know you summarized your testimony. It is very voluminous, as you stated. But it contains a lot of very valuable information in answer to some of the questions we raised earlier this morning. I want to assure you that the staff has looked it over and has told us that you have very interesting charts that have valuable data for us. So I personally want to thank you for it.

I have only one question. Can you give us a percentage of mortgage revenue bond with respect to the dollar, how much goes to the individual home buyer and how much goes to someone else?

Mr. BIRKLE. Based on the 1982 figures, 74 percent went to the intermediaries and the purchasers of bonds and only 26 percent actually benefited home buyers. Based on 1983 figures, because interest rates came down, about 57 percent went to the purchasers of the bonds, and that would leave 43 percent for the home buyers.

Mr. PICKLE. All right. I thank you very much for that data.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Birkle, your report has been criticized for studying the results of mortgage subsidy bonds only when interest rates were at an alltime peak. Would you expect your evaluation to change significantly if you studied 1983 results, when interest rates were at a relatively low point?

Mr. BIRKLE. Well, we did. That question came up earlier and we did go back and do additional work, and in our final report we will have information on 1983, and we also presented some here today.

The benefit to the home buyers does go up a little bit in 1983 because of the lower interest rates, but it is still a rather high percentage that is going to the purchaser of the bonds, 57 percent. And when you consider that, in our opinion it still makes the mortgage revenue bonds a very costly way to provide subsidies.

Chairman ROSTENKOWSKI. Have you discovered any cases of State or local governments issuing mortgage bond programs with their own funds? By their own funds, I mean receipts from their own taxes, not arbitrage earnings or previous issues or Federal grants.

Mr. GAINER. I think in 1982, because of the arbitrage restrictions and the fact that the points that would have had to be charged to buyers and sellers of homes were getting very high, most State governments did provide some funding, although it was a very small percentage of the amount actually lent. They did provide some subsidies to make the bonds work in 1982, but it was principally because of the arbitrary restrictions which forced them to do that.

Chairman ROSTENKOWSKI. Are there any further questions?

Mr. RANGEL. Yes, Mr. Chairman.

I do not think there is a problem with waste or inequity under the mortgage revenue bond system. But you constantly refer in your report to alternative programs that would be less costly and more equitable.

What programs are you talking about? Are you talking about Federal programs?

Mr. BIRKLE. We were talking about a tax credit or a direct grant. Now, I know that those things are not on the drawing board right now, so the Congress has a problem of deciding whether or not they need to pass these types of programs or whether you need to continue with what you have.

Mr. RANGEL. OK. But I think you could have easily said that, in terms of helping people acquire ownership of homes, based on what we have, this is the best thing going.

Mr. BIRKLE. Well, it is not the only thing going. There are other programs out there. The community development block grant program is providing money for homeownership which is helping some people.

Mr. RANGEL. Well, listen. Most of us recognize that there should be a better way to do it, but if we do not have the vehicles to improve the quality of housing stock, especially in low- and moderate-income communities, shouldn't we use the mortgage revenue bond system to attract people in? What your report is saying is that we should think of other ways, cheaper ways to do it.

If you heard HUD's report this morning, they are suggesting that we wait until the President's economic recovery package locks into place and then everyone can participate in the boom. I thought GAO did a great job meeting your specific objectives, and that was to test the mortgage revenue bond system. Is there a better way to do it?

But you would be the first to admit that in this administration, we do not have too many Federal alternatives to the mortgage bond.

Mr. BIRKLE. What would be the chances of a tax credit program getting through? I guess that is the question.

Mr. RANGEL. That is the question. And we will certainly be coming back. What specific recommendations can you make on how we can reach the same goals and objectives in a way that saves money to the taxpayer?

We are going to have to do the best we can with the tools we can get through Congress. I commend you for the job you have done based on the vacuum of alternative programs you have to work with.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Moore will inquire.

Mr. MOORE. Thank you, Mr. Chairman.

Mr. Birkle, can you tell the committee what the average income is of the bondholders who hold these bonds?

Mr. GAINER. We do not have any actual data on that. As far as I know, nobody has any data that has been developed in recent years. However, with the general increase in incomes over the years since the last time such a survey was taken, I think one could guess that it is well above the 40-percent tax bracket—although we did not use a 40-percent tax bracket in calculating our cost; we used 30 percent, as does Treasury and the Joint Tax Committee.

Mr. BIRKLE. We assumed bondholders incomes that are in the 30-percent tax bracket.

Mr. MOORE. Second, you listed some——

Mr. FRENZEL. Would the gentleman yield on that? Do you mean to tell me that you have assumed a bondholder is in the 30-percent tax bracket?

Mr. BIRKLE. Yes, probably a lot higher, but that makes for a conservative estimate.

Mr. **Gainer**. We assumed that because of the point that Mr. Downey raised this morning, namely, that people do not shift automatically from fully taxable investments to fully tax-exempt investments. There is probably a series of shifts of assets or investments between the issuance of $1 of tax-exempt bonds and somebody moving $1 into an equivalent taxable investment.

If you think about tax brackets and what people are getting in fully taxable investments, you would figure that that last shift might occur for somebody in the 20-percent tax bracket, whereas the first shift would be somebody going into a tax-exempt out of real estate or some partially taxed asset at an effective marginal tax bracket or 45 percent of higher.

When you then look at the distributions of incomes and tax brackets of those in the full chain of investment shifts, you come up with something around 30 percent, and that is the current thinking among economists as to what the effective marginal tax rate would be for estimating purposes.

Mr. **Frenzel**. Thank you.

I thank the gentleman.

Mr. **Moore**. I am just wondering, it seems to me you would have to be in a fairly high tax bracket to make tax-exempt bonds even worthwhile to you as an investment. I am a little startled that it is as low as 30 percent.

Mr. **Gainer**. On average, we do not think that the people who buy the bonds are at 30 percent. They are probably above 40 or 45 percent. But to attract enough investors for the volume of tax-exempts that have been issued in the last few years, you do have to get down into the 30's and perhaps below there. And it is providing yields to those taxpayers at the lower end of the spectrum of bond buyers that drives up the cost, because all those above that marginal rate where people become interested get a windfall.

Mr. **Moore**. You were listing a number of options in your testimony as to what could be done to tighten up the use of mortgage bonds. Have you considered an interest rate trigger? In other words, this program going into effect when interest rates are very high. This would be one of the few ways people could get reasonable interest rates.

Mr. **Birkle**. We did not specifically consider that, but we have heard here this morning what has been said about it, and it would seem like a very logical and worthwhile thing to do. If the mortgage revenue bond program is going to stay around, we think a trigger should be considered.

Mr. **Moore**. Could you take a look at it and give us what you think would be a historic rate for purposes of triggering in and triggering off the program, and any other analysis you could give us on that? I would appreciate your getting back to me and submitting the information for the record.

Mr. **Birkle**. We would be glad to.

Mr. **Moore**. I would appreciate it very much.

Thank you, Mr. Chairman.

Chairman **Rostenkowski**. Mr. Frenzel will inquire.

Mr. **Frenzel**. Thank you, Mr. Chairman.

Your testimony indicates that three out of four program beneficiaries would have been able to purchase homes without Government assistance, is that right?

Mr. **Birkle**. Yes, sir.

Mr. **Frenzel**. How did you determine that? Did you walk with them to the local lending officer and were you told that they would be delighted to make a loan to these folks?

Mr. **Gainer**. We necessarily had to estimate that, sir, but we think——

Mr. **Frenzel**. How did you do that?

Mr. **Gainer**. We think we did it in a fairly sensible way. We took the loan files for about 7,600 borrowers from seven States which we collected in the course of the study. This gave us the mortgage amount for that particular buyer and their income and certain other characteristics.

We then used the kind of underwriting standards that bankers were likely using in 1982 for a mixture of FHA, VA, and conventional loans, applied those underwriting standards to the incomes of these buyers, and determined whether or not at conventional interest rates of 15½ or 16½ percent they could have purchased homes.

Mr. **Frenzel**. Which did you use? Did you use 15½?

Mr. **Gainer**. We used both. We also used a variety of other segmentations of this group of buyers, and looking at it in a variety of ways we keep coming back to a figure of around three out of four. Some of our estimates are much higher—that perhaps 90 percent could have purchased the same homes at the same time.

Mr. **Frenzel**. Can you tell me what the average buyer's income was?

Mr. **Gainer**. The median in 1982 was someplace around $26,000.

Mr. **Frenzel**. If you were the steely eyed banker, what would be the value of a house that a $26,000 income person could have, assuming normal downpayments, which as I recall were rather high at this point?

Mr. **Gainer**. Under the mortgage revenue bond program the downpayments——

Mr. **Frenzel**. No. You are talking about whether a guy could get financing on the outside. I am trying to figure out what kind a home this chap could buy.

Mr. **Birkle**. They were about the same.

Mr. **Gainer**. Downpayments through uninsured loans tend to be quite a bit higher, perhaps about 20 percent. But most of the loans——

Mr. **Frenzel**. One of the things that is wrong with your analysis, is that you have assumed all these guys had a downpayment or some other form of financing. That is a rash assumption.

Mr. **Gainer**. I think we took that into account, because most of the loans that are included in the mortgage revenue bond program are also insured, which means that a reasonable percentage for downpayment would be about 10 percent for insured loans in this country.

Mr. **Frenzel**. That was not reasonable out in my area. I have to tell you, in my part of the country we were writing very few mortgage loans for guys with $26,000 of income during the period you made your analysis. And I cannot figure out any way, at least where I come from, how you could possibly have had alternative financing possibilities in three out of four cases or anywhere near that amount.

Mr. **Gainer**. The fact of the matter is that above incomes of about $20,000, people were qualifying for these mortgage revenue bond houses with low percentages of their incomes compared to the underwriting standards generally used by lenders.

Mr. **Frenzel**. $26,000?

Mr. **Gainer**. Yes, sir.

Mr. **Frenzel**. Well, I do not know what kind of a world you live in, but the next time I get a home mortgage I am going to take you with me.

I yield the balance of my time.

Chairman **Rostenkowski**. If there are no further questions, gentlemen, thank you very much for joining us.

The Chair calls Senator Howard, Mayor Latimer, Mr. Coffey, and Commissioner Knight. Gentlemen, welcome to the committee. I would like to restate our suggestion that if your statements are longer than the 5 minutes allocated to you, that you summarize. Your entire statement will be included in the record.

To further assist you in the time limitations, we have a lighting mechanism in front of you that changes from green to yellow to red. If you note the flickering of the red light, you have really overstepped your time. I am sorry that we have to be this concise. But as you recognize, the members of the committee do like to interrogate the administration witnesses in great depth.

Having said that, it is a pleasure to welcome you. We certainly recognize in your midst one of the outstanding members of the Congress, a representative from Texas—Sam Hall. We have on this committee several members of Congress from Texas.

Sam, it is a pleasure to have you here to introduce your witnesses.

With that, the time is yours.

INTRODUCTION BY HON. SAM B. HALL, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Mr. **Hall**. Thank you, Mr. Chairman.

It is a signal honor for me today to present to this committee the man that I think is a premier senator of the State of Texas, Senator Ed Howard of Texarkana, who represents the first senatorial district.

Senator Howard has been a member of the State Senate since 1979. He is chairman of some of the most important committees I think of that State. And I am just glad to be here and present him to you. I hope you will listen to what he says, because he always makes sense.

So with that, I yield back the balance of my time.

Mr. **Pickle**. I want to add my welcome to Senator Howard. Sam is right. He is one of the premier senators of our State, certainly one of them.

I particularly welcome Senator Howard here today because he has been one of those that originally had advanced the industrial development bond program, and yet who has recognized in recent years that there are abuses that should be corrected. He has had the courage to stand on the Senate floor of Texas and vote against the program in certain instances that he was so very fond of because he thought changes ought to be made. That takes courage, and it takes foresight.

So, Senator, we are glad to have you here.

Chairman **Rostenkowski**. Mr. Frenzel is recognized.

Mr. **Frenzel**. Mr. Chairman, Minnesota does not yield to Texas in its chauvinistic inclinations. I, therefore, would like to present to the chairman and the committee the distinguished mayor of the city of St. Paul who is ably represented by Congressman Bruce Vento. The Congressman is unable to be here today but has delegated me to tell you that he is one of the premier mayors of our State, just as your senator is one of the premier senators. We are proud to have him here, and we know the committee will enjoy his testimony.

Thank you, Mr. Chairman.

Chairman **Rostenkowski**. Thank you.

Now, gentlemen, we have gone through the congenial introductions. I will ask that we all yield to Mr. Knight who I understand has an airport engagement that he cannot afford to miss. So with your indulgence, we will receive the testimony from Mr. Knight and then receive the rest of your testimony.

Mr. Knight, you may proceed.

STATEMENT OF ROBERT KNIGHT, COMMISSIONER, WICHITA, KANS., AND COCHAIR, MUNICIPAL BOND TASK FORCE, THE NATIONAL LEAGUE OF CITIES

Mr. **Knight**. Thank you, Mr. Chairman and members of the committee.

First of all, I would like to apologize for not having anyone from Kansas on the House Ways and Means Committee.

My name is Bob Knight, and I am a city commissioner from Wichita, Kans. I am cochair of the NLC's municipal bond task force and a member of the NLC steering committee on finance administration and intergovernmental relations.

The National League of Cities represents approximately 15,000 cities directly and through their membership in 49 State municipal leagues. Our cities range in size from Scotland Neck, N.C. to New York City.

Lowering the cost and improving the marketability of municipal bonds for traditional purposes is one of the highest priorities of cities. A growing number of cities are having troubles both balancing their current operating budgets and borrowing for capital spending.

Faced with these budget challenges, cities have adopted stopgap actions in the short run which could compound longer term problems. Our spending priorities have been human crisis oriented: police and fire protection and health services. The resulting deteriorating condition of the Nation's cities' infrastructure—roads, bridges, public transit facilities, water and sewer systems—is evidence of earlier cutbacks in capital spending for repair and maintenance as well as deferral of new projects.

The estimated cost to stabilize current conditions, not even addressing improvements, are staggering. Chances for any near-term changes are bleak. Our survey of municipal fiscal conditions indicates that costs are increasing faster than revenues and that as a result most cities are increasing fees of various kinds, laying off employees and cutting services.

As the Continental Bank of Chicago reported recently:

> The impact of state and local governments' plight extends beyond their individual predicaments to the health and vigor of the overall economy.

Deficits and infrastructure needs have forced cities to borrow at a time of extraordinarily high interest rates, the highest in the history in real terms for municipal bonds. The deterioration in the municipal bond market caused cities to cancel over $680 million worth of long-term bond issues in 1981. The creation of new tax shelters, the tax changes reducing the attractiveness of municipal bonds to insurance companies, banks and individuals, the growing competition of industrial development bonds, and high interest rates have all wreaked havoc on municipal fiscal stability.

As the vice president of the Chase Manhattan Bank testified before the Joint Economic Committee:

> The problems are so pronounced that they could conceivably push some tax-exempt entities to or beyond the brink of bankruptcy.

Therefore, our members support the committee's interest in seeking a means to assure protection for the traditional public purposes of municipal bonds. We share your apprehension that bonds for these purposes are ill equipped to compete not only against the accelerating tax-exempt market for private, nontraditional purposes, but also at a time when the tax system has grown to provide a greater number of shelters and consequently less incentives for the purchase of municipal bonds.

We believe that unless tax-exempt issues are functionally and financially related to public issuers, they should not be afforded the privilege of a tax exemption.

In this regard we view government obligation and other traditional public purpose bonds as meriting full protection. In our view, Congress and the administration made efforts in this direction last year in the TEFRA legislation. Despite those changes, however, the current law provides little accountability in the way of an incentive for any State or local government to reject approval of an IDB. Consequently, we increasingly find ourselves in the position of approving IDB issues which, because they are more creditworthy than the current evaluation of fiscal and economic conditions in the Nation's cities, have a lower premium.

At the same time, I want to hasten to add that this committee bears a responsibility to approach these issues in a constructive fashion. As I have stated, cities and States are experiencing severe fiscal stress, a stress which is lagging behind any economic recovery.

Despite this distress, it is becoming increasingly clear that the burden of financing the Nation's cities' infrastructure needs at a price tag of over $50 billion in additional investment annually will fall upon cities.

More importantly, we hope the committee will consider more positive steps to assist the traditional public purpose sector. This committee in 1976 acted positively on the approach recommended by Senate Budget Committee Chairman Domenici for a taxable bond option. We believe the concept merits your consideration.

It is our view that constructive steps could be taken by the committee to make more marketable those bond issues which are critical to State and local governments.

Finally, Mr. Chairman, I would like to turn to the subject of mortgage subsidy bonds. NLC believes that there is a Federal role to support urban revitalization as well as home ownership opportunities for those who could not otherwise afford it.

We strongly believe that it would be wrong to exclude from Federal assistance just that portion of Americans who earn enough to be ineligible for direct Federal housing assistance, but not enough to be eligible for the very generous Federal tax subsidies which increase with the value of the home.

By the same token, we believe this should be a directed program with sufficient flexibility to enable cities to rebuild their neighborhoods and to help their working poor obtain adequate shelter.

Some cities, notably Minneapolis and Pittsburgh, have created innovative programs which would not have been possible except through this program. Therefore, the NLC supports a 3-year extension of mortgage subsidy bonds provided that: First, the volume of single family mortgage subsidy bonds in each State is limited to the greater of $100 million or a percentage of the average annual mortgage activity ranging from 3 percent when starts are over $1¾ million nationally to 9 percent when starts are under $1 million; second, no participant in a single family program have an income greater than the area median, and that the mortgage rate for the individual buyer be based on how far the buyer is from the median; and third, the single family program be limited to first-time home buyers.

I thank you for your consideration and the privilege of appearing before you.

[The prepared statement follows:]

Statement of Robert Knight, Commissioner, Wichita, Kans., on Behalf of the National League of Cities

Mr. Chairman and Members of the committee, my name is Robert Knight. I am Commissioner of the city of Wichita, Kansas, co-chair of NLC's Municipal Bond Task Force, and a member of NLC's Steering Committee on Finance, Administration, and Intergovernmental Relations.

The National League of Cities represents approximately 15,000 cities directly and through their membership in 49 state municipal leagues. Our member cities range in size from Scotland Neck, North Carolina to New York City.

Lowering the cost and improving the marketability of municipal bonds for traditional purposes is one of the highest priorities of cities. A growing number of cities are having troubles both balancing their current operating budgets and borrowing for capital spending. Faced with these budget crises, cities have adopted stop-gap actions in the short run, which could compound longer-term problems. Our spending priorities have been human crisis oriented: police and fire protection and health services. The resulting deteriorating condition of the nation's cities' infrastructure--roads, bridges, public transit facilities, water, and sewer systems--is evidence of earlier cutbacks in capital spending for repair

AND MAINTENANCE, AS WELL AS DEFERRAL OF NEW PROJECTS. THE ESTIMATED COSTS TO STABILIZE CURRENT CONDITIONS--NOT EVEN ADDRESSING IMPROVEMENTS--ARE STAGGERING. CHANCES FOR ANY NEAR TERM CHANGES ARE BLEAK.

THE EROSION OF OUR INFRASTRUCTURE, IN TURN, INCREASES THE COST OF OPERATIONS. MAINTENANCE AND REPAIR COSTS ARE INCREASED. SEWER MORATORIUMS RESTRAIN INDUSTRIAL GROWTH AND OPPORTUNITIES. POOR TRANSPORTATION FACILITIES LEAD TO CONGESTION AND DELAYS, NOT TO SPEAK OF INCREASED WEAR AND TEAR ON ALL VEHICLES.

MOREOVER, DURING THIS PERIOD OF RECESSION, FEDERAL AID TO CITIES HAS DECLINED SUBSTANTIALLY. WE NOW RECEIVE $300 MILLION LESS IN COMMUNITY DEVELOPMENT BLOCK GRANTS THAN IN FY 1981. EPA WASTEWATER GRANTS HAVE BEEN REDUCED FROM NEARLY $4 BILLION TO $2.4 BILLION. ECONOMIC DEVELOPMENT ASSISTANCE, FROM THE EDA AND UDAG PROGRAMS, HAS BEEN REDUCED FROM ABOUT $1.2 BILLION IN FY 1981 TO ABOUT $650 MILLION CURRENTLY.

OUR SURVEY OF MUNICIPAL FISCAL CONDITIONS INDICATES THAT COSTS ARE INCREASING FASTER THAN REVENUES AND THAT, AS A RESULT, MOST CITIES ARE INCREASING FEES OF VARIOUS KINDS, LAYING OFF EMPLOYEES, AND CUTTING SERVICES. AS THE CONTINENTAL BANK OF CHICAGO REPORTED RECENTLY: "THE IMPACT OF STATE AND LOCAL GOVERNMENTS' PLIGHT EXTENDS BEYOND THEIR INDIVIDUAL PREDICAMENTS TO THE HEALTH AND VIGOR OF THE OVERALL ECONOMY."

DEFICITS AND INFRASTRUCTURE NEEDS HAVE FORCED CITIES TO BORROW AT A TIME OF EXTRAORDINARY INTEREST RATES--THE HIGHEST IN HISTORY IN REAL TERMS FOR MUNICIPAL BONDS. THE DETERIORATION IN THE MUNICIPAL BOND MARKET CAUSED CITIES TO CANCEL OVER $680 MILLION WORTH OF LONG-TERM BOND ISSUES IN 1981.

THE CREATION OF NEW TAX SHELTERS; THE TAX CHANGES REDUCING THE ATTRACTIVENESS OF MUNICIPAL BONDS TO INSURANCE COMPANIES, BANKS, AND INDIVIDUALS; THE GROWING COMPETITION OF INDUSTRIAL DEVELOPMENT BONDS; AND HIGH INTEREST RATES HAVE ALL WREAKED HAVOC ON MUNICIPAL FISCAL STABILITY. AS THE VICE PRESIDENT OF THE CHASE MANHATTAN BANK TESTIFIED BEFORE THE JOINT ECONOMIC COMMITTEE, "THE PROBLEMS ... ARE SO PRONOUNCED THAT THEY COULD CONCEIVABLY PUSH SOME TAX EXEMPT ENTITIES TO OR BEYOND THE BRINK OF BANKRUPTCY."

THEREFORE, OUR MEMBERS SUPPORT THE COMMITTEE'S INTEREST IN SEEKING A MEANS TO ASSURE PROTECTION FOR THE TRADITIONAL PUBLIC PURPOSES OF MUNICIPAL BONDS. WE SHARE YOUR APPREHENSION THAT BONDS FOR THESE PURPOSES ARE ILL-EQUIPPED TO COMPETE, NOT ONLY AGAINST THE ACCELERATING TAX EXEMPT MARKET FOR PRIVATE, NON-TRADITIONAL PURPOSES, BUT ALSO AT A TIME WHEN THE TAX SYSTEM HAS GROWN TO PROVIDE A GREATER NUMBER OF SHELTERS AND, CONSEQUENTLY, LESS INCENTIVES FOR THE PURCHASE OF MUNICIPAL BONDS.

WE BELIEVE THAT UNLESS TAX EXEMPT ISSUES ARE FUNCTIONALLY AND FINANCIALLY RELATED TO PUBLIC ISSUERS, THEY SHOULD NOT BE AFFORDED THE PRIVILEGE OF A TAX EXEMPTION. IN THIS REGARD, WE VIEW GOVERNMENT OBLIGATION AND OTHER TRADITIONAL PUBLIC PURPOSE BONDS AS MERITING FULL PROTECTION. IN OUR VIEW, CONGRESS AND THE ADMINISTRATION MADE EFFORTS IN THIS DIRECTION LAST YEAR IN THE TEFRA LEGISLATION. DESPITE THOSE CHANGES, HOWEVER, THE CURRENT LAW PROVIDES LITTLE IN THE WAY OF AN INCENTIVE FOR ANY STATE OR LOCAL GOVERNMENT TO REJECT APPROVAL OF AN IDB. CONSEQUENTLY, WE INCREASINGLY FIND OURSELVES IN

THE ANOMALOUS POSITION OF APPROVING IDB ISSUES WHICH, BECAUSE THEY ARE MORE CREDIT WORTHY THAN THE CURRENT EVALUATION OF FISCAL AND ECONOMIC CONDITIONS IN THE NATION'S CITIES, HAVE A LOWER PREMIUM.

AT THE SAME TIME, I WANT TO HASTEN TO ADD THAT THIS COMMITTEE BEARS A RESPONSIBILITY TO APPROACH THESE ISSUES IN A CONSTRUCTIVE FASHION. AS I HAVE STATED, CITIES AND STATES ARE EXPERIENCING SEVERE FISCAL STRESS, A STRESS WHICH IS LAGGING BEHIND ANY ECONOMIC RECOVERY. DESPITE THIS DISTRESS, IT IS BECOMING INCREASINGLY CLEAR THAT THE BURDEN OF FINANCING THE NATION'S CITIES' INFRASTRUCTURE NEEDS--AT A PRICE TAG OF OVER $50 BILLION IN ADDITIONAL INVESTMENT ANNUALLY--WILL FALL UPON CITIES.

AS DIRECTED BY EXISTING FEDERAL POLICY UNDER THIS ADMINISTRATION, CITIES HAVE LOOKED MORE TO THE PRIVATE SECTOR. SINCE THE PASSAGE OF ERTA, CITIES HAVE SOUGHT TO MAKE UP FOR THE LOSS OF DIRECT FEDERAL INFRASTRUCTURE ASSISTANCE TO MEET MANDATED FEDERAL REQUIREMENTS AND TO PROVIDE EMERGENCY SERVICES TO THE UNEMPLOYED, ELDERLY, AND POOR THROUGH LEVERAGING PRIVATE INVESTMENT.

WE UNDERSTAND AND SHARE THE APPREHENSION OF SOME MEMBERS OF THE COMMITTEE OVER THE POTENTIAL LOSS OF REVENUES TO THE TREASURY IN THE OUTYEARS FROM THESE PRACTICES. BUT WE CANNOT SUPPORT AN APPROACH WHICH APPEARS SO DISCRIMINATORY AGAINST PUBLIC VERSUS PRIVATE-FOR PROFIT PURPOSES, NOR ONE WHICH HAS DEVELOPED WITH SO LITTLE CONSULTATION WITH THE AFFECTED LEVELS OF GOVERNMENT. BECAUSE WE SHARE COMMON CONCERNS AND GOALS, WE WOULD URGE THE COMMITTEE TO GIVE THE MOST CAREFUL CONSIDERATION TO THE IMPACT OF H.R. 3110.

More importantly, we hope the committee will consider more positive steps to assist the traditional, public purpose sector. This committee in 1976 acted positively on the approach recommended by Senate Budget Committee Chairman Domenici for a taxable bond option. We believe the concept merits your consideration. It is our view that constructive steps could be taken by the committee to make more marketable those bond issues which are critical to state and local governments.

Finally, Mr. Chairman, I would like to turn to the subject of mortgage subsidy bonds.

NLC believes that there is a federal role to support urban revitalization, as well as homeownership opportunities for those who could not otherwise afford it. We strongly believe that it would be wrong to exclude from federal assistance just that portion of Americans who earn enough to be ineligible for direct federal housing assistance, but not enough to be eligible for the very generous federal tax subsidies which increase with the value of the home.

By the same token, we believe this should be a directed program with sufficient flexibility to enable cities to rebuild their neighborhoods and to help their working poor obtain adequate shelter. Some cities, notably Minneapolis and Pittsburgh, have created innovative programs which would not have been possible except through this program.

Therefore, NLC supports a three year extension of mortgage subsidy bonds provided that--

--the volume of single family mortgage subsidy bonds in each state is limited to the greater of $100 million or a percentage of average annual mortgage activity, ranging from 3 percent when starts are over 1.75 million nationally to 9 percent when starts are under 1 million.

--no participant in the single family program have an income greater than the area median and that the mortgage rate for the individual buyer be based on how far the buyer is from the median.

--the single family program be limited to first-time homebuyers.

I should add that we believe the Congress, in addressing the issue of mortgage subsidy bonds, might want to consider other suggestions:

- The indirect federal subsidy could be viewed as an equity participation. Thus, those beneficiaries who realize enough growth in income to rollover their initial homeownership investment should be required to refund that percentage of the home's appreciation equal to the amount of interest subsidy provided.
- The mortgage subsidy bond program has been criticized for various weaknesses. The Congress should commission a study of the program, with local participation, to assess its costs and benefits, to recommend improvements, and to evaluate alternative programs that might have greater efficiency from a federal revenue perspective.

Chairman ROSTENKOWSKI. Thank you, Mr. Knight.

Senator Howard, you may proceed.

STATEMENT OF HON. ED HOWARD, TEXAS STATE SENATOR, VICE CHAIRMAN, TEXAS STATE FINANCE COMMITTEE, ON BEHALF OF THE NATIONAL CONFERENCE OF STATE LEGISLATURES

Mr. HOWARD. Thank you, Mr. Chairman and members.

My name is Ed Howard. I am a member of the Texas Senate, and I am here today representing the National Conference of State Legislatures.

Over the years I have been involved in activities at the State level on tax-exempt bonds, and I share your concern, as do many other State legislators throughout the country.

NCSL represents all 50 State legislatures, and I am pleased to speak on their behalf today.

The States have had a problem, too, with the debt situation and the issuance of these types of bonds. At the State level as well as the Federal level, revenue bonds have been rising at a higher rate than the general obligation bonds. The States have recognized that; many have undertaken studies that would give States better management of their debt. Also adding to our difficulties are severe financial problems. This past year some 28 States have had to turn to tax increases. Because of this, we have been concerned about meeting our debt structure and at the same time, we have been concerned with economic development. Concentrated economic efforts in our States are trying to address, trying to respond to economic development and to respond to the needs of the citizens simultaneously.

Various States have also undertaken active programs to get a better grasp on the local debt including industrial development bonds. However, the debt situation in these States is not strictly the result of industrial revenue bonds. Other things can be attributed, in my opinion, to the problem that we face.

The State legislatures, in my opinion, have reexamined the bonds to determine if there really is a valid public purpose involved. In many States legislation has been introduced—it has not been quite as successful as we would like it to have been—to limit the use of these types of bonds. Yet, at the same time, bonds that would expand the use have been more successful.

Industrial development bonds, we feel, are necessary to provide subsidies for some purposes, for example, the low-income multifamily housing units. This purpose and the small issue development bonds play a key role in types of financing for housing and small businesses. NCSL believes that trying to preserve and expand local economies and preserve the health of the bond market are two goals that we need to and you need to address. Perhaps by restriction of the industrial revenue bonds, we could accomplish this goal.

The NCSL policy dealing with this legislation is that we support Congressman Pickle and H.R. 1635, the legislation that would limit the use of small issue IDB's. We know that the lobbying efforts of the beneficiaries has expanded this type of program, especially in the area of commercial projects. This is the area that gives me the greatest trouble, personally, and in our State, because of the rapid expansion.

In Texas we initially introduced legislation primarily aimed at industrial and manufacturing purposes. We did try to limit commercial projects using areas designated similar to your UDAG—we call them economically blighted areas—so that it could be limited somewhat to areas requiring extraordinary assistance.

The NCSL would oppose restrictions that would add to the financial or administrative burdens of States and that did not directly address the abuses of the bonds.

I want to hurriedly go then to the mortgage revenue bonds. We feel that this is a viable program. It has enabled many millions of people to, for the first time, participate in home buying. In Texas we used the federally mandated purchase price limits as well as the income limits. We feel this is necessary.

I do have, at the chairman's request, comments on possibility or feasibility of a State-by-State volume cap for industrial bonds. We believe that on State-issued bonds such a cap would be administratively and politically very difficult.

On the local level, we think that it would be almost impossible to do because of the number of issues and the number of issuing authorities. We just do not believe that would be a workable solution.

On behalf of the NCSL, I do appreciate the opportunity to testify today, and I would be happy to answer any questions, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF SENATOR ED HOWARD, VICE CHAIRMAN, TEXAS SENATE FINANCE COMMITTEE, ON BEHALF OF THE NATIONAL CONFERENCE OF STATE LEGISLATURES

MY NAME IS ED HOWARD. I AM VICE CHAIRMAN OF THE TEXAS SENATE FINANCE COMMITTEE AND I AM HERE TODAY REPRESENTING THE NATIONAL CONFERENCE OF STATE LEGISLATURES. I HAVE BEEN EXTENSIVELY INVOLVED AT THE STATE LEVEL OVER THE YEARS IN LEGISLATION DEALING WITH TAX-EXEMPT BONDS AND SHARE THE COMMITTEE'S CONCERN IN THIS AREA AS DO MANY OTHER STATE LEGISLATORS THROUGHOUT THE COUNTRY. NCSL REPRESENTS ALL FIFTY STATE LEGISLATURES AND I AM PLEASED TO SPEAK ON THEIR BEHALF TODAY.

TRENDS AND CONCERNS IN STATE DEBT

YOU HAVE HEARD MUCH OVER THE PAST SEVERAL YEARS ABOUT THE TAX-EXEMPT BOND MARKET AND THE CREDIT NEEDS OF STATES AND LOCALITIES. LIKE OTHER SECTORS STATE DEBT HAS RISEN RAPIDLY WITH THE ISSUANCE OF BONDS NOT BACKED BY THE FULL FAITH AND CREDIT OF THE STATES RISING AT A RATE HIGHER THAN THAT OF GENERAL OBLIGATION BONDS. SPECIAL AUTHORITIES SET UP TO BUILD BRIDGES, PORTS AND OTHER FORMS OF INFRASTRUCTURE HAVE BEEN CREATED OVER THE YEARS TO GIVE STATES MORE FLEXIBILITY IN FINANCING CAPITAL PROJECTS.

DESPITE CONSERVATIVE MANAGEMENT OF THEIR DEBT (NINE STATES HAVE NO OUTSTANDING GENERAL OBLIGATION DEBT AT ALL), STATES HAVE FACED ERODING CREDIT QUALITY AND BOND RATINGS. IN 1982, ONLY TWO STATES HAD BOND RATINGS RAISED, WHILE SEVEN HAD RATINGS LOWERED, SOME MORE THAN ONCE DURING THE YEAR. THIS IS NOT A REFLECTION OF BOND VOLUME OR DEBT MANAGEMENT, BUT A REFLECTION OF THE DETERIORATING FISCAL CONDITION OF STATE GOVERNMENTS. AFTER SEVERAL YEARS OF CUTTING EXPENDITURES TO MEET CONSTITUTIONAL AND STATUTORY REQUIREMENTS FOR BALANCED BUDGETS, SOME TWENTY-EIGHT STATES HAVE TURNED TO TAX INCREASES SO FAR THIS YEAR. MANY OVER THE PAST TWO YEARS HAVE RAISED EXCISE TAXES, ACCELERATED TAX PAYMENTS, OR USED INTERFUND BORROWINGS. THIS YEAR, HOWEVER, NINE HAVE TURNED TO BROAD-BASED SALES TAX INCREASES AND SIX TO PERSONAL INCOME TAX INCREASES.

As a result, states have concentrated on economic development efforts, bolstering their economies, and responding to the needs of citizens also feeling the impact of recession and high interest rates. Also looming on the horizon is the growing pressure for infrastructure financing which will increase borrowing in the credit markets.

Despite this pressure states have acted to increase oversight of state and local debt. In recent years California, Oregon, Vermont, Maryland, New Hampshire, Michigan, Kentucky, Illinois and Wisconsin have all undertaken significant reviews and reforms of their debt issuance practices. In Texas, the Industrial Commission monitors all industrial development bonds issued by localities to assess the types of projects and their effectiveness. Entities such as the Maryland Debt Affordability Committee have been created, debt studies undertaken as Oregon and debt limits imposed in other states to insure that debt does not rise disproportionately.

This heightened concern over debt issuance in general, and revenue debt in particular, has caused many legislators to re-examine the types of bonds which in a limited fiscal world can still be regarded as being for "valid public purposes." Over the past several years many states have attempted to pass legislation which would have limited the use of certain types of debt with a number of bills directly aimed at use of small issue industrial development bonds. The track record of these bills has not been good. I am not pleased to say that the track record of those seeking to expand use of these bonds for additional purposes in many states has been better.

I am sure members of Congress having recently debated this issue understand some of the difficulty in agreeing on a proper course of action. It is particularly difficult at the state and local level to say "no" when jobs that have been promised are at stake and tax benefits of this type are available from

THE JURISDICTION NEXT DOOR.

WE DO NOT BELIEVE THESE DECISIONS HAVE BEEN MADE CAVALIERLY OR PURPOSELY TO HAVE THE FEDERAL TREASURY PAY FOR LOCAL DEVELOPMENT. MANY INDUSTRIAL DEVELOPMENT BONDS ARE USED RESPONSIBLY AND IN CASES SUCH AS LOW-INCOME MULTI-FAMILY HOUSING, PROJECTS WOULD NOT BE CONSTRUCTED WITHOUT SUCH SUBSIDIES TO BORROWING COSTS. FOR MANY SMALL BUSINESSES THE COMPARABLE BORROWING RATE WOULD NOT BE THE TAXABLE CORPORATE BOND RATE, BUT BANK LOANS WELL ABOVE THE PRIME INTEREST RATE. SMALL ISSUE DEVELOPMENT BONDS PLAY A KEY ROLE IN THIS TYPE OF FINANCING. SEVERAL STATES SUCH AS CONNECTICUT AND MASSACHUSETTS HAVE BEEN ABLE TO RETAIN A SIGNIFICANT NUMBER OF JOBS AND PROVIDE ESSENTIAL ASSISTANCE FOR SMALL BUSINESSES USING THESE BONDS. WE BELIEVE THAT THE CONTROLS PASSED AS PART OF TEFRA WERE AN HONEST ATTEMPT ON THE PART OF THE CONGRESS TO ADDRESS THIS PROBLEM. ALTHOUGH IT MAY BE TOO SOON TO MAKE DEFINITIVE STATEMENTS ABOUT THEIR IMPACTS, NCSL BELIEVES THAT THEIR IMPACT MAY NOT HAVE TARGETED THE USE OF BONDS AS EFFECTIVELY AS THIS COMMITTEE HAD HOPED.

NCSL BELIEVES, AS I AM SURE MEMBERS OF THE COMMITTEE DO, THAT EXPANDING OUR LOCAL ECONOMIES AND PRESERVING THE HEALTH OF THE BOND MARKET ARE EQUALLY IMPORTANT GOALS. IN THE PAST, BOTH HAVE BEEN ACCOMODATED, BUT NOW MAY BE OUT OF BALANCE. THE BOND MARKET, HOWEVER, IS NOT SUFFERING BECAUSE OF INDUSTRIAL DEVELOPMENT BOND VOLUME ALONE. AS YOU HAVE HEARD BEFORE, ACTIONS SUCH AS LOWERING THE MARGINAL TAX RATES, REDUCTIONS IN THE CAPITAL GAINS RATES, EXPANSIONS IN OTHER INCOME-SHELTERING OPPORTUNITIES SUCH AS THE ALL-SAVERS CERTIFICATES, AND CHANGES IN THE TAXATION OF COMMERCIAL BANKS HAVE ALSO CAUSED DETERIORATION OF THE TAX-EXEMPT MARKET. INCREASED FEDERAL BORROWING ALSO COMPETES WITH BOTH TAX-EXEMPT AND CORPORATE SECURITIES.

NCSL BELIEVES ADDRESSING THE CONCERNS OVER INCREASING USE OF SMALL ISSUE INDUSTRIAL DEVELOPMENT BONDS IS ONE STEP IN REVERSING THIS SITUATION. WE WOULD

STRONGLY URGE THE COMMITTEE, HOWEVER, TO CONSIDER THESE OTHER TYPES OF IMPACTS IN DETERMINING FUTURE TAX POLICIES.

NCSL POLICY

GIVEN THIS CONCERN OVER THE AVAILABILITY OF A HEALTHY BOND MARKET FOR FUTURE FINANCING AND THE DIFFICULTY OF ENACTING LIMITATIONS ON SMALL ISSUE INDUSTRIAL DEVELOPMENT BONDS ON A PIECEMEAL BASIS, NCSL WOULD SUPPORT LEGISLATION WHICH WOULD LIMIT THE USE OF SMALL ISSUE BONDS TO SMALL BUSINESSES AND PROJECTS WHICH WOULD INCREASE THE PERMANENT JOB BASE OF THE COMMUNITY. IN TEXAS, WE ATTEMPTED TO MAINTAIN THE USE OF INDUSTRIAL DEVELOPMENT BONDS FOR MANUFACTURING AND INDUSTRIAL FACILITIES, HOWEVER, LOBBYING BY BENEFICIARIES, THOSE WHO BELIEVE SUCH TAX INCENTIVES SIGNIFICANTLY SPUR DEVELOPMENT, AND LOCALITIES GENUINELY CONCERNED OVER STATE CONTROL OF LOCAL FINANCES HAS RESULTED IN SIGNIFICANT EXPANSION PARTICULARLY IN THE AREA OF COMMERCIAL PROJECTS.

IN SUPPORTING FEDERAL ACTION NCSL RECOGNIZES, HOWEVER, THAT SOME CONSIDERATION SHOULD BE GIVEN TO AREAS OF PARTICULAR DISTRESS. WE WOULD URGE THE COMMITTEE IN DESIGNING RESTRICTIONS TO PROVIDE SOME RELIEF FOR THESE AREAS. WE WERE SUCCESSFUL IN TEXAS IN PASSING LEGISLATION TO LIMIT COMMERCIAL PROJECTS TO AREAS DESIGNATED BY LOCAL OFFICIALS AS NEEDING EXTRAORDINARY ASSISTANCE. I WOULD AGAIN STRESS THAT WE DO NOT BELIEVE ALL INDUSTRIAL DEVELOPMENT BONDS TO BE INHERENTLY WRONG, SIMPLY MISUSED. I HAVE PROVIDED THE COMMITTEE WITH A STUDY RECENTLY COMPLETED BY THE TEXAS INDUSTRIAL COMMISSION ON COMMERCIAL PROJECTS. IT ANALYZES THE SIZE, LOCATION, TYPE OF PROJECT, NUMBER OF JOBS CREATED, ESTIMATES OF TAX GENERATED, AND COST BENEFIT ANALYSIS FOR EACH PROJECT. WE HAVE USED THIS STUDY TO MAINTAIN A CLOSE WATCH ON THE TYPE AND NECESSITY OF PROJECTS FUNDED. WE WOULD OPPOSE RESTRICTIONS WHICH WOULD ADD TO THE FINANCIAL OR ADMINISTRATIVE BURDENS OF STATES AND LOCALITIES, BUT DID NOT ACT TO DIRECTLY ADDRESS THE ABUSES IN THE USE OF THE BONDS. REQUIRING A CONTRIBUTION BY THE

COMMUNITY ON ALL IDB PROJECTS PENALIZES BOTH GOOD AND BAD. ALTHOUGH THIS APPROACH NO DOUBT WOULD INCREASE SCRUTINY OF PROJECTS, HARD-PRESSED AREAS MAY NOT BE ABLE TO FINANCE VAILID, NECESSARY USES. STATES AND LOCALITIES COULD MORE EFFECTIVELY CONTROL THE INDIVIDUAL PROJECTS FUNDED THROUGH THESE BONDS IF THE UPWARD SPIRAL EXPANDING THEIR USE COULD BE STOPPED.

MORTGAGE REVENUE BONDS

AS I MENTIONED AT THE BEGINNING OF MY TESTIMONY, STATES HAVE CONCENTRATED NOT ONLY ON BOLSTERING THEIR ECONOMIES, BUT ALSO ON RESPONDING TO THE NEEDS OF CITIZENS HARD HIT BY THE CURRENT RECESSION. NCSL BELIEVES THE USE OF MORTGAGE REVENUE BONDS HAS BEEN IMPORTANT IN THIS EFFORT. OVER THE PAST TWO YEARS UNPRECEDENTED HIGH INTEREST RATES HAVE PREVAILED CLOSING MILLIONS OF POTENTIAL HOMEBUYERS OUT OF THE HOUSING MARKET. STATES AND LOCALITIES ACTED DURING THIS TIME BY ISSUING SINGLE-FAMILY MORTGAGE REVENUE BONDS UNDER FEDERAL GUIDELINES TO ASSIST THESE FAMILIES. ALTHOUGH THE MAGNITUDE OF THIS PROGRAM HAS ABATED SOMEWHAT SINCE CONVENTIONAL INTEREST RATES HAVE DROPPED, MANY IN THE HOMEBUYING MARKET AND HOMEBUILDING INDUSTRY CONTINUE TO NEED ASSISTANCE.

IN TEXAS WE HAVE BOTH THE FEDERALLY MANDATED PURCHASE PRICE LIMITS AS WELL AS INCOME LIMITS ON THE PROGRAM TO INSURE THAT ASSISTANCE GOES TO MODERATE INCOME FAMILIES AND FIRST-TIME HOMEBUYERS. THIS IS THE POPULATION WHO SHOULD BE SERVED BY THIS PROGRAM AND NCSL BELIEVES THE CONGRESS SHOULD EXTEND THE USE OF THE BONDS FOR THESE PEOPLE.

AT THE STATE LEVEL A "SUNSET" PROVISION INDICATES THAT A PROGRAM WILL BE EXAMINED AND ITS BENEFITS AND COSTS WEIGHED, NOT THAT A PROGRAM AUTOMATICALLY EXPIRES. WE HOPE THAT THIS COMMITTEE WILL DETERMINE AFTER HEARINGS AND INVESTIGATION THAT MORTGAGE BONDS TO CONSTITUTE A VALUABLE USE OF STATE AND LOCAL CREDIT AND CAN BE USED RESPONSIBLY. A RECENT ARTICLE IN THE BOND BUYER INDICATED THAT THE VOLUME OF BONDS FOR HOUSING SOLD IN MAY REPRESENTED 7% OF THE

MONTH'S TOTAL WHEREAS THEY REPRESENTED SOME 24% OF THE TOTAL ISSUES FOR MAY 1982. THE CUMULATIVE HOUSING FIGURE FOR THE YEAR HAS ALSO DECLINED ALTHOUGH NOT AS DRAMATICALLY. MORTGAGE REVENUE BONDS REPRESENT A PROGRAM WHERE VOLUME IS CONTROLLED AND WHERE LOSSES TO THE FEDERAL TREASURY ARE LIMITED.

IT IS MY UNDERSTANDING THAT MUCH OF THE DEBATE OVER MRB'S AND OTHER TAX-EXEMPT BONDS CENTER ON THEIR "INEFFICIENCY" WITH DIRECT SUBSIDIES SAID TO OFFER GREATER EFFICIENCY IN FINANCING PUBLIC PROJECTS. ALTHOUGH TO AN EXTENT THIS IS UNDENIABLY TRUE, NCSL BELIEVES THAT THE FEDERAL GOVERNMENT CANNOT BE EXPECTED FISCALLY OR POLITICALLY TO PROVIDE THESE SUBSIDIES OVER THE SHORT-TERM OR PARTICULARLY THE LONG-TERM WHEN FACING GROWING DEFICITS.

CONCLUSION

LET ME CONCLUDE MY REMARKS BY ADDRESSING ONE OTHER PROPOSAL. THE COMMITTEE IN CALLING THESE HEARINGS REQUESTED COMMENTS ON THE FEASIBILITY OF A STATE-BY-STATE VOLUME CAP FOR ALL INDUSTRIAL DEVELOPMENT BONDS. AT THE STATE LEVEL FOR STATE-ISSUED BONDS, SUCH A CAP WOULD BE ADMINISTRATIVELY AND POLITICALLY DIFFICULT, BUT ONE WHICH COULD BE FEASIBLE. LET ME HASTEN TO ADD THAT NCSL WOULD NOT BE IN FAVOR OF SUCH A CAP BECAUSE OF THESE DIFFICULTIES.

HOWEVER, AT THE LOCAL LEVEL, WE BELIEVE SUCH A CAP WOULD BE TOTALLY UNWORKABLE AND PRODUCE NEAR CHAOS IN SORTING OUT THE MYRIAD OF SPECIAL DISTRICTS AND ISSUING AUTHORITIES AND ASSIGNING VOLUME LIMITATIONS. ALTHOUGH EFFECTIVE FROM THE FEDERAL PERSPECTIVE IN LIMITING REVENUE LOSSES, SUCH A SIMPLE SOLUTION WOULD NOT ADDRESS THE QUESTION OF ABUSES IN THE USE OF THESE BONDS EVEN IF APPROPRIATE MEASURES COULD BE DEVISED TO SET CAPS ON THE TYPES OF USES. THE CAP ON MORTGAGE REVENUE BONDS IS BASED ON A VOLUME OF PRIVATE ACTIVITY WHICH IN ITSELF HAS BEEN DIFFICULT TO DETERMINE. NO SUCH MEASURES EXIST FOR AIRPORTS, PORTS, OR LOW-INCOME HOUSING. WE WOULD URGE THE COMMITTEE NOT TO ADOPT THIS APPROACH AND CONTINUE TO ADDRESS THE ADMITTEDLY MORE DIFFICULT TASK OF WEEDING OUT ABUSES IN EACH AREA.

AGAIN, ON BEHALF OF NCSL, WE APPRECIATE THE OPPORTUNITY TO PRESENT OUR VIEW ON THESE BONDS. I DO NOT ENVY THE COMMITTEE ITS TASK. HAVING BEEN IN YOUR POSITION AT THE STATE LEVEL, I AM UNDER NO ILLUSION OF ITS DIFFICULTY, BUT WISH YOU SUCCESS IN YOUR EFFORTS.

Chairman ROSTENKOWSKI. Mr. Latimer, you may proceed.

STATEMENT OF HON. GEORGE LATIMER, MAYOR OF ST. PAUL, MINN., ON BEHALF OF THE U.S. CONFERENCE OF MAYORS AND THE LEAGUE OF MINNESOTA CITIES

Mr. LATIMER. Mr. Chairman and members of the committee, I am George Latimer, mayor of the city of St. Paul. I am representing today my city, the League of Minnesota Cities, and the U.S. Conference of Mayors.

In deference to this committee's time and to Mr. Coffey, who will follow me, I am going to be brief to the point of bluntness. I ask first, Mr. Chairman, that my written testimony with its attachments be accepted.

Chairman ROSTENKOWSKI. Your entire statement will be included in the record.

Mr. LATIMER. Thank you.

I would like to make three points:

No. 1, let us look a little bit at what has brought about the use of both of these tools before we fiddle with them or before we alter, modify, or reject them. The city of St. Paul, for example, is an old and cold city that is landlocked, with no expandability in acquiring new land. We cannot just annex land. By using our port authority revenue bonding, we have created 9,000—created or retained 9,000 jobs in the past 6 years. I think that is terribly important.

In the area of mortgage financing, even post-Ullman we have combined mortgage revenue bonding together with foundation funding to reach a wide variety of people of several income groups. It is true that the first group we have met has been referred to by Mr. Frenzel, and I would like to give you a specific individual case that worked in St. Paul, would not work without the revenue bonding.

It does not go to rich people. It goes to people of moderate income who would not otherwise get into housing. A person with a $26,000 annual income, which is below our median household income, was able to acquire a $60,000 piece of property in St. Paul as a result of revenue bonding with the McKnight funding.

Without it, the person would need an income of $36,000. Out of the market that would leave those people, Mr. Frenzel, as your question would suggest, out of the market.

As far as the revenue bond is concerned, we support the repeal of the sunset as far as the tax-exempt revenue financing. We ask that there be no change at this time, that you take more time to find out what the real numbers are as a result of the revenue financing.

I am keeping my pledge by being very brief. I look forward to the few minutes we might have for questions and answers. And I must tell you, I not only thank you for inviting me but I have been impressed by the attention and the level of the questioning of the members of this committee, and I have had the pleasure of listening to you all day. And that is an unusual opportunity, for one politician to remain silent while others are speaking.

Thank you.

[The prepared statement follows:]

STATEMENT OF MAYOR GEORGE LATIMER, U.S. CONFERENCE OF MAYORS AND LEAGUE OF MINNESOTA CITIES

SUMMARY

1. The United States Conference of Mayors and the League of Minnesota Cities support H.R. 1176, which would eliminate the December 31, 1983, sunset date on Mortgage Revenue Bonds, and call for its immediate enactment.
2. The Mortgage Revenue Bond Act of 1980, Public Law 96-499, has limited the use and volume of Mortgage Revenue Bonds exactly as Congress intended.
3. Purchasing a home is an expensive undertaking out of the reach of many American households. Single-family mortgage revenue bonds have facilitated home buying for many households which would otherwise have been unable to afford conventional mortgages.
4. The United States Conference of Mayors and the League of Minnesota Cities oppose H.R. 1635 which would further restrict the use of tax-exempt Industrial Revenue Bond financing by local units of government.
5. The Conference opposes additional restrictions on Industrial Revenue Bonds until the experience of the restrictions imposed by Congress under the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) is known. The Conference would recommend an additional two years waiting period to allow proper evaluation on TEFRA's affect on the issuance of IDB's.
6. The Conference of Mayors has adopted a policy which encourages its members to act responsibly in using IDB's during this two-year evaluation period.

STATEMENT

Good morning Mr. Chairman and members of the Committee. My name is George Latimer. I am the Mayor of St. Paul, Minnesota, a city of approximately 270,000 population and the capital city of Minnesota.

I appear before you today on behalf of the U.S. Conference of Mayors—an organization of the chief elected local officials from cities of 30,000 or more population throughout the country and on behalf of the League of Minnesota Cities, an organization of some 750 municipal governments in Minnesota. I am a member of the Advisory Board of the Conference and former chair of the Standing Committee on Community Development, Housing and Economic Development. I am past president of the Minnesota League and currently a member of the Board of Directors. I note to you that the Minnesota League carries the views of cities of all sizes from throughout my great home state.

The positions of both organizations on H.R. 1176 and H.R. 1635 are similar. I have enclosed the prepared statement of the League of Minnesota Cities as Exhibit A to this statement.

H.R. 1176, MORTGAGE REVENUE BONDS

I will first address my comments to H.R. 1176, which would repeal the December 31, 1983, sunset date for single-family mortgage revenue bonds which was established by Congress under the Mortgage Revenue Bond Act of 1980 (Public Law 96-499). The Conference of Mayors calls for the enactment of H.R. 1176 to allow cities to continue to provide affordable housing through the use of single-family mortgage revenue bonds.

Financing is the single greatest hurdle faced by those who wish to buy a home. For most Americans, owning a home is the dream of a lifetime. A home is the most expensive purchase most Americans make, and often our only investment. It is difficult enough for most people to buy a house, but for those with low and moderate incomes, it is virtually impossible to afford conventional mortgages.

Single-family mortgage revenue bonds (MRB's) alleviate this problem. As interest rates climbed in the late 1970's, many individuals—who otherwise might have been able to buy homes—found that inflation diluted downpayments which had been laboriously set aside. At the same time, inflation drove housing prices higher and higher and a tight money policy made interest rates border on the absurd. "Good buys" in housing became harder and harder to find.

The development of single-family financing through tax-exempt bonds was a response to this need for low-cost: housing finance. The introduction of legislation in 1979 to limit the use of the bonds because of perceived "overuse" and consequent revenue loss to the Federal Government resulted in an unfortunate screeching halt to all single-family projects.

Congress recognized the unfairness of that approach and enacted transition rules which enabled many stalled projects to be completed, including a much acclaimed program in my city known as the Minneapolis-St. Paul Family Housing Fund. Purchase price limitations and statewide volume limitations were imposed on single-family bond programs by the Mortgage Revenue Bond Act of 1980 (Public Law 96-499). This limitation accomplished exactly what seemed to be the Congress' intent: To severely restrict the use of single-family mortgage revenue bonds and to target their use to low and middle income families. In addition, Public Law 96-499 provided a "sunset" date on the program of December 31, 1983, so that the program would die unless Congress acted positively to extend this financing incentive. The Conference of Mayors believes that a Congressional review of the use of single-family mortgage revenue bonds since the adoption of Public Law 96-499 will reveal the solid accomplishments of state and local agencies, thus, meriting the repeal of the sunset date.

Our experience in St. Paul is echoed in other cities represented by the Conference of Mayors. For example, the Minneapolis-St. Paul Housing Fund program, a joint program of the Cities of Minneapolis and St. Paul and financially assisted by the McKnight Foundation, has provided 800 units of additional housing in St. Paul, with a comparable number in Minneapolis. The average adjusted gross income level of the St. Paul home buyers assisted under the program was $24,500, compared to the average median income of the Minneapolis-St. Paul SMSA of $31,600. The average purchase price was $65,300. Eighty-five (85) percent of the buyers were formerly renters, with 35 percent new to the city.

I understand this Committee's concern that the state and local which have impact on federal revenues warrant periodic review. It is the Congress' responsibility and duty to be absolutely certain that revenues are foregone only for useful purposes and fine causes.

The Conference of Mayors is certain that providing quality housing at affordable prices is perhaps one of the most useful and finest services our tax dollars can provide. I urge this committee to report H.R. 1176 favorably and without amendment.

H.R. 1635, INDUSTRIAL REVENUE BONDS

Next I will comment on H.R. 1635 which would impose additional restrictions on the use of Industrial Revenue Bond financing. Specifically, the proposal would require that depreciable property financed with IDB's, except rental housing, be depreciated on a straight-line basis over ACRS recovery periods, restrict the use of "small issue" IDB's to those firms with total capital expenditures on a world-wide basis of less than $20 million during a three-year period prior to issuance and eliminate the use of IDB's to acquire land.

The Conference of Mayors and the League of Minnesota Cities oppose additional restrictions on Industrial Revenue Bonds until such time that the impact of the restrictions enacted by Congress under the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) can be evaluated. The Conference recommends that no further restrictions be imposed for an additional two-year period to allow enough experience under the new law for meaningful valuation.

In addition, the Conference of Mayors had adopted a policy of self-regulation with respect to the use of IDB's by its membership. The Conference encourages responsible and restrained use of IDB financing consistent with Congress' intent in imposing the existing restrictions relating to straight-line depreciation for projects financed by IDB's, public hearing and reporting requirements, elected official approval of all IDB issues, the 1986 sunset date for small issue IDB's and a requirement all IDB's be registered securities.

The Conference encourages Congress to restrain itself in adopting any additional changes to allow the reporting mechanisms under existing law to generate information to allow meaningful analysis to occur.

The Conference and the League of Minnesota Cities feel that Industrial Revenue Bonds are a critical component in allowng local officials to encourage economic development. I would like to share my experience in using IDB's to promote economic revitalization of my city.

In the past five years St. Paul has witnessed unprecedented redevelopment in both our neighborhoods and our downtown. Small issue Industrial Development Bonds have contributed significantly to this redevelopment by providing access to long-term financing at affordable rates for small and medium sized projects.

In 1982 St. Paul issued approximately $100 million in small issue Industrial Development Bonds. Through these issues the city had a striking impact on its land development at a very minimal cost to the federal treasury. In fact, had all of that

$100 million of development been financed conventionally the revenue to treasury would have been no more than $7 million and more likely $5 million. What other federal subsidy can boast a consistent average of 20 to one. Furthermore, St. Paul leads its sister cities in our region in job growth, in part because we have used this tool to finance commerce and industry which no longer finds conventional capital available to them, or when it does, cannot begin to support the terms and rates which are now 15–17 percent with seven year balloon payments.

St. Paul can and does show restraint in its use of this tool we have in place a rigorous application and review process to determine the public purpose of each tax-exempt financing which includes published notice, public hearing, citizen participation, design review, land use planning review and guidelines for labor standards on construction projects. Furthermore, we have used tax-exempt financing to encourage downtown projects to convert to district heating.

Tax-exempt financing has significantly increased the city's opportunity to impact land development by broadening our span of involvement in private development activities. At no other time in history have we had as much involvement with as many projects in our city. For additional information on development in St. Paul financed by IDB's, I refer you to Exhibit B.

St. Paul is proud of the development leveraged by the small IDB. Last year alone we issued a $5.8 million bond to finance a $9 million mixed-use rental housing project with specialty retail, in one of the city's most blighted, low-income neighborhoods. We also passed a preliminary resolution for $7 million renovation of the Union Depot, a significant St. Paul landmark, which has been vacant for approximately 10 years.

The current proposals to arbitrarily limit IDB financing by adopting tax law restrictions may have a differential impact on developed cities. Before Congress imposes further restrictions, a rigorous cost-benefit analysis of this tool should be undertaken which studies its impact on cities like St. Paul based on the restrictions and reporting requirements of the 1982 law. If further restrictions are indicated, then Congress should continue to address the use of the tool. The current proposals introduced by H.R. 1635 may have the effect of providing disincentives in St. Paul and other cities to those projects which, in our opinion, have the highest public purpose at this time in our history.

Mr. Chairman, I would be happy to respond to questions from the Committee members.

EXHIBIT A.—LEAGUE OF MINNESOTA CITIES, STATEMENT TO HOUSE WAYS AND MEANS COMMITTEE ON H.R. 1176 AND H.R. 1635

The League of Minnesota Cities represents some 750 cities of all sizes in Minnesota. We support the continued availability of the industrial and mortgage revenue bonds in their present form. Therefore we support H.R. 1176 continuing mortgage revenue bonds and oppose H.R. 1635 restricting industrial revenue bonds.

Tax-exempt mortgage revenue bonds have played an important role in Minnesota in providing housing opportunities for low and moderate income Minnesotans. Use of these bonds has also had the additional beneficial effect of providing jobs in the beleaguered housing industry and providing capital for the rehabilitation and preservation of Minnesota Cities. Minnesota cities alone issued a total of $106,841,000 in mortgage revenue bonds in 1982. These bonds financed new construction, and housing rehabilitation loans. Appendix A summarizes the state mortgage revenue bond activities handled by the State Housing Finance Agency from 1973 to 1982.

Similarly, the state of Minnesota and its cities have been active users of industrial revenue bonds. IRBs are efficient tools which allow cities to take an active role in fostering a diverse range of economic development or redevelopment. Furthermore, they are the primary means by which cities can provide and maintain employment opportunities within the city. Their continued availability is crucial to the economic health of Minnesota cities.

While we recognize the need to control the federal deficit, we feel that the federal costs associated with tax-exempt revenue bonds have been overestimates. Revenue loss estimates do not take into account the savings in federal unemployment expenditures made possible by the private sector jobs created by state and local mortgage revenue bond programs. Furthermore, these federal revenue loss estimates incorrectly assume that investors in tax-exempt revenue bonds will invest in table securities shoudl tax-exempt revenue bonds be eliminated. It is more likely that such investors will choose to invest in other tax-sheltered opportunities in the absence of tax-exempt revenue bonds. Finally, it is not clear that reduction of tax-exempt bonds will produce more federal tax revenues. Some reports indicate that increased personal income tax revenues gained by elimination of tax-exempt securities will be offset by the decreased corporate tax revenues resulting from the higher interest deductions due to unavailability of low interest financing.

Restriction of these financing tolls at this time is inappropriate becuase of the inadequate information concerning the effect such restrictions will have. Any restrictions should at least be delayed until the effects can be accurately evaluated based on information which will become available after July, 1983 when tax-exempt bonds will be registered.

More importantly, we feel that it is especially inappropriate to discontinue these tools when employment, development, and housing opportunities are extremely scarce. The league feels that the benefits realized due to tax/exempt bonds far outweight any potential savings which may be made possible by their elimination. Thus we urge Congress to support their continued availability.

APPENDIX A.—MORTGAGE REVENUE BONDS, THE MINNESOTA HOUSING FINANCE AGENCY RECORD, 1973-1982

I. CUMULATIVE VOLUME

(All data are current as of September 30, 1982.)

A. Home Mortgage Loans: $475,690,000—bonds sold; $20,260,000—State appropriations; $389,352,000—mortgage loans purchased; 11,783—mortgate loans purchased; $8,50,000—Homeownership Assistance Fund (HAF) loand provided; 2,700 Homeownership Assistance Fund (HAF) loans provided; $2,181,800—Vietnam Era Veterans downpayment assistance loans; 555—Vietnam Era Veterans downpayment assistance loans.

B. Home Improvement Loans: $191,505,000—bonds sold; $33,410,000—State appropriations; $176,406,000—loans purchased; 34,426—loans purchased; $992,000—rental rehabilitation loans purchased; 62—rental rehabilitation loans purchased.

II. DEMOGRAPHIC CHARACTERISTICS

A. Home Mortgage Lonas, 1980-81: Average household income: $17,000; Average house price: $43,562; Average mortgage amount: $40,205; Interest rate: 9.25 percent; Average monthly principal and interest payment: $331; Percent new construction: 35 percent; Average age of head of household: 27.5 years; Average household size: 2.3 people.

B. Home Improvement Loans, 1982: Average household income: $16,000; Average loan amount: $6,286; Average loan term: 12 years; Average age of head of household: 41 years; Average household size: 2.9 people; Average age of home: 51 years.

III. ESTIMATED ECONOMIC IMPACT

A. Home Mortgage Loans (June 1982-June 1983): Based on the assumption that 60 percent of the $70 million in loan funds will be used for newly constructed homes, the program should generate the following economic benefits: Approximately 510 construction jobs; Approximately 1,105 off-site jobs; Approximately $28 million in personal income for the construction workers and other workers; Approximately $1.2 million in State income taxes generated by the above jobs; Approximately $1,970,000 in State unemployment compensation payments saved by the employment of approximately 510 construction workers.

B. Home Improvement Loans (January 1982-June 1983): Approximately 2,950 jobs; Approximately $28 million in personal income for the above workers; Approximately $1.4 million in State income taxes generated by the above jobs.

IV. INNOVATION, LEVERAGING AND INVOLVEMENT OF THE PRIVATE SECTOR

A. Energy Efficient Housing Demonstration Program: In 1980 the Agency decided to use a limited pool of low interest mortgage loan funds to stimulate the construction of highly energy efficient homes which would serve as a model for architects, builders, home buyers, lenders and local officials throughout the State. The benefits of the program have been numerous. One hundred forty-four moderate income households have purchased their first homes, which are up to four times as energy efficient as a typical home being built in Minnesota today (many of these home owners spent less than $200 to heat their homes during the very cold winter of 1981-82). Thousands of Minnesota residents toured the 23 model homes or received literature about the homes' special energy conserving features. Scores of builders and architects received a detailed technical manual on energy efficient construction and many have incorporated at least some of these methods into their regular residential construction practices. Data obtained by monitoring both the actual construction and the occupants' actual energy use are being analyzed and shared with interested parties throughout the country. Lessons learned from the demonstration are being integrated into other MHFA programs.

B. State Board of Investment (SBI): In the summer of 1982 MHFA sold $70 million of 11 year bonds to provide below market rate "growing equity" mortgage loans with 22 year terms. This was made possible by a landmark agreement between MHFA and SBI, whereby SBI agrees to purchase all outstanding loans not in default 11 years from now, thus paying off the bonds. The agreement provides SBI with a sound investment at competitive yields and gives it the opportunity to invest in Minnesota. A portion of the sale also involves a six year tender option with a Minnesota bank which further reduces the cost of the bond sale and thus lowers the amount of appropriations needed to make the issue feasible. The result of these innovative agreements is that homebuyers benefit through lower interest rates, the construction industry benefits through increased business activity and the State economy benefits through increased taxes and reduced unemployment compensation costs.

C. Rental Rehabilitation Loan Program: By using prepayments from home improvement loans made with proceeds of bond issues sold before passage of the Mortgage Subsidy Bond Tax Act of 1980, the Agency has been able to make rental rehabilitation loans for the last two years. The Agency has also been selected to participate in a demonstration program sponsored by the U.S. Department of Housing and Urban Development (HUD) in cooperation with eight Minnesota communities. Under the demonstration Agency funds will be matched with community development block grant funds (CDBG) to finance improvements to rental units occupied by low and moderate income tenants. HUD is providing 150 Section 8 "existing" certificates which would not otherwise have been available to Minnesota. Local communities benefit from an improvement in their housing stock in locally targeted areas, tenants benefit from improved units at affordable rents, landlords benefit from affordable financing and increased property values, and the State benefits from reduced consumption of expensive and limited energy resources.

D. Medium Density and "Rollover" Housing: The Agency is developing two demonstration programs designed to meet special homeownership needs. The first would encourage the construction of moderately priced, energy efficient, for-sale attached housing. The priority is to stimulate construction of such housing in communities where there is a market for such housing, but the housing is not currently available. Emphasis will be placed on efficient land use, energy conservation, affordability and meeting locally established housing goals. The second program is designed to promote more efficient use of the existing housing stock by enabling "empty nesters" to sell their "underoccupied" homes to young families and move into smaller housing units which better meet their current housing needs.

E. Private Sector Involvement: MHFA single family programs are financed and monitored by the Agency, but are essentially operated by the private sector. Approximately 160 lending institutions are currently making Agency home mortgage loans and approximately 280 are currently making Agency home improvements loans. All loans are serviced by Minnesota lenders, homes are sold by Minnesota real estate agents, new homes are built by Minnesota builders, home improvements are done by Minnesota homeowners and Minnesota contractors, and materials and supplies are purchased from Minnesota businesses.

EXHIBIT B.—THE ECONOMIC IMPACT OF THE PORT AUTHORITY OF THE CITY OF ST. PAUL, FINAL REPORT, MRI PROJECT NO. 7055-N, MARCH 31, 1981

SUMMARY OF KEY FINDINGS

St. Paul is a developed central city located within an expending metropolitan area. As such St. Paul has limited remaining land within its boundaries for the expansion and renewal of its economic base. In spite of this significant constraint, St. Paul's economy has performed well since 1965. A substantial portion of this development can be attributed to the activities of the St. Paul Port Authority.

EMPLOYMENT IMPACTS

The Port Authority of the City of St. Paul has had a significant impact on St. Paul employment since 1965. Port Authority projects have directly affected 16,460 current jobs since 1965, or 9 percent of all St. Paul jobs. This represents 63 percent of St. Paul's job growth from 1965 to 1980.

When you adjust to reflect only those jobs that the Port Authority attracted or saved for St. Paul and consider the secondary impact of these jobs the effective impact of the Port Authority since 1965 ranges from 18,563 to 21,188 jobs. The share of St. Paul employment ranges from 10 percent to 12 percent and the share of growth from 71 percent to 82 percent.

The maximum employment impact if you can count all jobs where the Port Authority was involved is 30,530 jobs. This represents 17 percent of all St. Paul jobs in 1980 and 117 percent of the growth since 1965.

St. Paul's manufacturing employment has declined substantially less than either Minneapolis' or Duluth's since 1965. St. Paul manufacturing jobs dropped by 4 percent from 1965 to 1980 while Minneapolis lost 26 percent and Duluth 29 percent of its manufacturing jobs. St. Paul Port Authority activities have essentially made the difference in manufacturing jobs.

St. Paul's manufacturing job decline was greater than DesMoines, Iowa from 1967 to 1977; however, St. Paul's manufacturing job performance was better than that of Omaha, Nebraska; Kansas City, Missouri; and Milwaukee, Wisconsin over the ten-year period.

St. Paul's nonmanufacturing job growth since 1965 exceeded that of Minneapolis and was comparable with Duluth's. St. Paul nonmanufacturing employment increased by 23 percent from 1965 to 1980, compared with 11 percent for Minneapolis and 24 percent for Duluth.

Approximately one-third of St. Paul's jobs are in the service or in the finance, insurance, and real estate sectors. St. Paul's job growth for these industries exceeded both Minneapolis' and Duluth's. St. Paul's service employment growth was 64 percent from 1965 to 1980 compared with 41 percent for Minneapolis and 30 percent for Duluth. St. Paul's finance, insurance, and real estate jobs increased by 25 percent since 1965 while the same sectors in Minneapolis and Duluth increased by 18 percent. Since 1975, the St. Paul Port Authority has placed a strong emphasis on attracting or retaining service industry jobs. Much of the job impact of these activities will be experienced in the next two years as recent projects are completed.

Most of Duluth's growth occurred in the retail trade area. Duluth's retail trade job growth was 39 percent since 1965, compared with a 9 percent decrease for St. Paul and a 3 percent decrease for Minneapolis. The Duluth growth can be explained by the depressed state of the Duluth economy in the mid-1960's, the growth of the regional economy, and retail development projects in the 1970's. Retail trade in St. Paul and Minneapolis was affected by declining population and suburban center growth during the 1960's and 1970's. St. Paul and Minneapolis should both show stronger increases in retail trade employment in the 1980's as a result of downtown development projects started in the late 1970's and the stabilization and reversal of population decline.

As the state capital, St. Paul experienced its fastest growth in government-related jobs. St. Paul government jobs increased by 74 percent since 1965, compared with 62 percent for Duluth and 52 percent for Minneapolis. Government-related jobs accounted for one-fifth of all St. Paul jobs in 1980. Given the likely budget cuts by both state and federal governments, decreases in employment for this sector can be expecting in the early 1980's.

SALES/VALUE ADDED IMPACTS

St. Paul's total gross sales are estimated to have been $8.6 billion in 1980. St. Paul Port Authority projects generated an estimated $1.6 billion in gross sales in 1980 or 19 percent of total St. Paul sales.

By adjusting for Port Authority impact and secondary sales impacts, the actual effect of Port Authority projects ranges from $1.6 billion to $2.0 billion, or from 19 to 24 percent of gross sales.

If all sales of businesses affected by the St. Paul Port Authority are attributed to the Port Authority, the maximum impact is $25 billion, or 29 percent of all St. Paul sales.

St. Paul led Minneapolis and Duluth as well as DesMoines, Kansas City, Milwaukee, and Omaha in growth of value of shipments by manufacturing firms from 1967 to 1977.

Total value added for St. Paul in 1980 is estimated to have been $4.8 billion. Of this amount Port Authority projects contributed an estimated $833 million or 18 percent of the total.

St. Paul manufacturing value added rose from $860 million in 1967 to $1.5 billion in 1977, an increase of 6 percent a year. During the same ten year period, Minneapolis' value added grew from $852 million to $1.3 billion, an increase of 4.5 percent a year, Duluth's value added for manufacturing industries rose from $90 million in 1967 to $152 million in 1977, a 5.4 percent annual increase.

St. Paul's value added by manufacturing firms grew more slowly than value added for Omaha and DesMoines from 1967 to 1977; however, St. Paul's value added growth exceeded growth for Milwaukee and Kansas City over the ten-year period.

CAPITAL EXPENDITURE IMPACTS

The level and growth of capital expenditures is a key indicator of the future health of St. Paul industry Capital investments stimulated by the Port Authority have had and will continue to have a significant impact on St. Paul's economic health.

Total capital expenditures by Port Authority firms since 1965 are $523 million based on the MRI survey of current Port Authority firms. Of this, $199 million were invested by manufacturing firms. Total capital investment in plant and equipment by all St. Paul manufacturing firms since 1965 is estimated to be $839 million. St. Paul Port Authority projects thus accounted for 24 percent of the capital expenditures by St. Paul manufacturing firms since 1965.

Taking into account future capital investments committed by Port Authority actions through 1980 and past projects which are no longer active total cumulative capital investment is $707 million.

Capital expenditures of St. Paul manufacturing firms rose at an annual average growth rate of 8.3 percent a year from 1967 to 1977, compared with 2.8 percent a year for Minneapolis and 6.7 percent a year for Duluth.

St. Paul's manufacturing capital expenditure growth lagged behind Kansas City's and Omaha's from 1967 to 1977; but St. Paul led DesMoines and Milwaukee in new capital expenditure growth over the ten years.

PROPERTY TAX AND VALUATION IMPACTS

St. Paul businesses assisted by the Port Authority paid $4.7 million in property taxes to local government in 1980. This represents 10 percent of the $47 million in taxes paid by all St. Paul firms.

St. Paul commercial-industrial assessed valuation rose from $268 million in 1972 to $410 million in 1980, an increase of $142 million. The assessed valuation of Port Authority firms increased by $27 million since 1972, or 19 percent of the St. Paul increase.

The St. Paul commercial-industrial tax base grew more rapidly than that of other Minnesota central cities during the 1970's. St. Paul's commercial-industrial assessed valuation increased 53 percent from 1972 to 1980, compared with 39 percent growth for Minneapolis and 43 percent growth for Duluth. Furthermore, St. Paul used tax increment financing much less than Minneapolis and Duluth. The commercial-industrial assessed valuation increase benefitted taxpayers more in St. Paul than in either Minneapolis or Duluth, where a greater share of the increase was needed to retire tax increments bonds.

LAND DEVELOPMENT

The Port Authority's principal development tool has been the industrial land it controls in St. Paul. A major obstacle for government agencies attempting to promote or direct development has been the fact that they do not control the land which they would like developed. The Port Authority has controlled sufficient vacant industrial land over the past 15 years so that the city could offer businesses several locational options.

The St. Paul Port Authority has developed or committed more than 750 acres of vacant St. Paul industrial land since 1965. This represents 73 percent of the net land area available for Port Authority development projects, including Energy Park.

Before 1965, the St. Paul Port Authority developed 2 percent of St. Paul's total industrial acreage. Since 1965, the Port Authority has developed or committed more than 16 percent of the city's total industrial area. With the industrial land currently available to the Port Authority, an additional 3 percent of the city's industrial acreage can be developed in the future.

As St. Paul industrial land has been developed and less land is available for new industrial projects, the St. Paul Port Authority has shifted its emphasis to offsite developments. Before 1970, the St. Paul Port Authority had no offsite projects outside of industrial areas. Between 1970 and 1974, the Port Authority assisted with two offsite projects. From 1975 through 1980, the Port Authority was involved in 64 offsite projects, or 54 percent of the projects in the period.

DEVELOPMENT TOOLS

The St. Paul Port Authority is a semi-autonomous government agency which acts as a business promotion and service agency, land developer, property manager, and financial intermediary for the City of St. Paul. The Port Authority generates income from the lease and sale of Authority-controlled properties as well as interest on Port Authority investments. These revenues are used to manage Port Authority properties, to promote additional private investments in St. Paul, and to provide a reserve fund for revenue bonds issued by the Port Authority. The St. Paul Port Authority has been particularly effective in integrating property and financial management to have maximum impact on St. Paul's economic development.

The principal financial tool of the St. Paul Port Authority is the industrial revenue bond. The authority to issue revenue bonds has been given to the St. Paul Port Authority by the Minnesota State Legislature. The Port Authority may issue revenue bonds in St. Paul subject to approval by the St. Paul City Council.

The St. Paul Port Authority has used its financial resources to make the industrial revenue bond a more effective tool for economic development in St. Paul. The Port Authority uses accumulated funds from land leasing and sales and interest on investments as a reserve against revenue bond defaults. This approach has allowed the Port Authority to obtain an A rating for revenue bonds issued by the Port Authority. The A rating makes the bonds more salable and allows the Port Authority to obtain a more favorable interest rate for its clients. Furthermore, there is no financial risk to St. Paul taxpayers.

With income generated from leasing and sales, the Port Authority is able to make investments in Port Authority properties or assist in St. Paul development projects to stimulate private investment. For example, the Port Authority paid for soil correction on a site in Riverview Industrial Park to attract Brown & Bigelow and built the parking ramp for the Town Square project. The Port Authority is also playing a major role in providing the local investment required to develop the St. Paul Energy Park.

FINANCIAL PERFORMANCE

Assets of the St. Paul Port Authority grew at a very high rate from 1965 to 1980—19 percent a year or 13 percent a year when adjusted for inflation. Capital growth was not as great as asset growth but still was high for the 15 year period—13 percent a year in current dollars or 7 percent a year in constant dollars.

Government obligation (G.O.) bonds backed by city tax revenues played an important part in getting Port Authority development activities started. Now, however, revenue bonds, which do not risk city tax dollars, are the major portion of Port Authority bonds outstanding. In 1965 G.O. bonds were 87 percent of bonds outstanding; in 1980 G.O. bonds were less than 10 percent of bonds outstanding.

The St. Paul tax contribution is more than offset by taxes paid on Port Authority properties. The city tax contribution was nine-tenths of taxes paid by Port Authority properties in 1965; the tax contribution was less than one-tenth of taxes paid in 1980.

In spite of the spectacular growth in assets, Port Authority operating expenses have remained modest. Operating expenses grew 8 percent a year from 1965 to 1980, or less than 2 percent a year when adjusted for inflation.

CONCLUSION

The St. Paul Port Authority has expanded its role from managing terminal facilitties and limited industrial development in 1965 to broad-based industrial and commercial development for the city by 1980. This expanded role reflects the increasing importance of service industries to the economy of St. Paul.

The Port Authority has used its powers and tools of land development, industrial revenue bonds, and financial leveraging effectively to enhance the St. Paul economy. An example of the Port Authority's effectiveness is the use of its accumulated financial resources to obtain an A rating for its revenue bonds.

The flexible and businesslike approach of the St. Paul Port Authority has, in fact, made a difference in St Paul, and at minimal cost to St. Paul taxpayers. Furthermore, as a result of Port Authority activities, the City of St. Paul has not had to resort extensively to tax increment financing which commits future tax resources and can affect the city's bond rating.

Unless a fully developed city such as St. Paul takes a proactive role in economic development, it will lose its job base. If this occurs, there will be dislocations of population which may in the long-run entail substantial public cost.

The St. Paul Port Authority should continue to focus its efforts on attraction and retention of industrial jobs. However, the city is rapidly running out of land to support this kind of development. Service industry job growth and retention offer the best opportunities for St. Paul Port Authority impact in the 1980's. Particular emphasis should be given to those service industry segments which are most mobile, such as business services.

It is important that the Port Authority continue to have access to its current development tools if it is to have an impact on St. Paul's economy in the 1980's. These tools may need to be modified or improved to reflect changes in the region's economic and financial structure. Also, as the functioning of a service economy is better understood, these and other development tools can be used more effectively.

In the 1980's, the Port Authority well need to focus more heavily on job retention, business expansion, and industrial and commercial facility reuse. There will be less opportunity than in the past for new business attraction and vacant land development. The activities of the Port Authority in the last few years indicate that the Port Authority and its staff have already begun to make this shift.

Chairman ROSTENKOWSKI. Thank you, Mr. Latimer.

Mr. Coffey, you may proceed.

STATEMENT OF MATTHEW B. COFFEY, EXECUTIVE DIRECTOR, NATIONAL ASSOCIATION OF COUNTIES

Mr. COFFEY. Thank you, Mr. Chairman.

My name is Matthew Coffey. I am the executive director of the National Association of Counties.

As you have heard from the other witnesses, the trend in municipal finance is that the demand for services is increasing while the sources of revenue are increasingly being restricted. Measured by national income accounts, local governments now face deficits. It is telling that the administration recently lowered their GNP estimates because local governments were lagging in this recovery.

Municipal bonds traditionally have been an attractive investment, but they have become less attractive to investors because of the competition from all-savers accounts, IRA's, coupled with the limitation on deductibility of interest and bond registration requirements. All of these things have exerted upward pressure on the interest rates for municipal securities.

Local project financing expense as a result has increased. In response, local governments have raised taxes where they can. I would point out, Mr. Chairman, that 38 States now have local tax caps, most local governments being at those caps.

Second, they have used creative financing techniques, such as sale and leaseback as provided in the Tax Code.

Third, they have attempted to expand industries through the use of industrial revenue bonds.

We need all these tools, Mr. Chairman, to survive. Last year the National Association of Counties supported restrictions on small issue IRB's which were incorporated into TEFRA. The result has been that the volume of small issue IRB's has stayed reasonably constant, despite the fact that these just went into effect in January. As you will see in Ms. Rivlin's testimony, the volume from year to year has varied by one tenth of 1 percentage point. Therefore, we would recommend that you not impose additional restrictions at this time, giving us enough time to look at this over a full year period. And therefore we would urge you not to impose these restrictions that are in H.R. 1635 at this time, because by further restricting these bonds you are going to make it a lot tougher to attract or expand industry locally, particularly in depressed areas.

We do not object to the section 3 provision on federally insured deposits.

In summary, we believe many of the so-called private purpose financing uses serve a public purpose, particularly housing and industrial development projects. We believe local officials are capable of deciding locally what constitutes a public purpose, and we feel further restrictions will only make the job of generating and supporting economic development harder.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF MATTHEW B. COFFEY, EXECUTIVE DIRECTOR, NATIONAL ASSOCIATION OF COUNTIES

Good morning, I am Matthew B. Coffey, executive director of the National Association of Counties, the only national organization that represents county government.[1]

I am appearing before you today to comment upon what NACO perceives to be the major issues currently affecting municipal financing, to express the concern of NACO's member counties about additional restrictions on the use of industrial revenue bonds that have been proposed in H.R. 1635, and to briefly discuss legislation to extend the issuance of mortgage revenue bonds and restrict the use of sale leasebacks by State and local governments.

TRENDS IN MUNICIPAL FINANCING

With regard to trends in municipal financing, it is evident that State and local governments currently are mired in an unprecedented situation of fiscal distress. The combination of a prolonged and severe recession, substantial cutbacks in Federal aid, and recent Federal tax code changes has adversely affected the financing capability of many jurisdictions. State and local per capita revenues and expenditures have declined as a result, although demand for services has remained strong and, in the health and human services areas, has accelerated sharply due to the recession. The length and severity of the recession and the fact that it followed so quickly upon the heels of the 1980 downturn have depleted the revenue reserves of State and local governments. Since 1978, the fiscal position of State and local governments, as measured by the national income accounts, has eroded from one of substantial surpluses to one of significant deficits. Consequently, although the economy has begun to improve, State and local governments have not rebounded as rapidly as in the past.

Cutbacks in Federal aid have intensified the negative effects of the recession. NACO estimates that since the 1981 Reconciliation Act, counties have sustained over a 15-percent reduction in Federal funding. Many have been forced to reduce employment, cut back on essential social services and postpone badly needed investment in infrastructure repairs.

The third element adversely affecting the financing capability of State and local governments is recent changes in the Federal tax Code which have effectively rendered municipal bonds less attractive as an investment. These include the tax cuts contained in the Economic Recovery Tax Act of 1981, the creation of all savers certificates, liberalization of individual retirement accounts, limitation of the deductibility of interest paid by banks on debt incurred to purchase or carry municipal bonds under the corporate minimum income tax, bond registration requirements, and other changes. These measures have increased competition for investment and exerted upward pressure on interest rates of municipal securities, making it more expensive for State and local governments to finance capital projects and operations.

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[1] The National Association of Counties is the only national organization representing county government in the United States, through its membership, urban, suburban, and rural counties join together to build effective, responsive county government. The goals of the organization are to: Improve county governments; serve as the national spokesman for county government; act as a liaison between the Nation's counties and other levels of government; achieve public understanding of the role of counties in the Federal system.

The response of State and local governments to these negative fiscal influences has occurred in three major areas. First, many have raised taxes; second, many have utilized creative financing techniques, such as sale leasebacks, to fund capital improvements and operations; and, third, most have attempted to attract commerce and industry to their jurisdictions and/or strengthen their already existing industrial and commercial institutions. This last response is one geared toward long range growth of the State and local tax base, and industrial revenue bonds are a major mechanism used by State and local governments to encourage such tax base growth.

INDUSTRIAL REVENUE BONDS

NACO believes that the continued use of industrial revenue bonds should be permitted because they are needed now more than ever by State and local governments as these jurisdictions struggle to recover from the recession.

Last year during consideration of the Tax Equity and Fiscal Responsibility Act, a special NACO task force on industrial revenue bonds examined the question of IRB issuance by State and local governments and recommended that NACO support certain restrictions on small-issue IRB use. The task force was concerned that the unchecked proliferation of small-issue IRB's could adversely affect the municipal bond market by crowding out traditional public purpose bond issues and increasing the interest costs of jurisdictions issuing bonds. It was also concerned about the potential Federal revenue loss resulting from rapid growth of these bonds, although there was considerable disagreement among experts as to the existence and amount of these revenue losses. On the basis of task force recommendations. NACO ultimately adopted a policy that called for the following restrictions: Approval of all small-issue IRB's by the highest elected governing body of the issuing jurisdiction following a public hearing; reporting of all small issues; elimination of retail commercial and recreational uses of small-issue IRB's for all but economically distressed areas; agreement by users of small-issue IRB's to an equal employment opportunity commitment.

It was NACO's conviction that the imposition of these limitations would correct the abuses of small-issue IRB's that had occurred, would assure that small-issue IRB's would serve the public purposes of stimulation of capital formation and job development, but would not so drastically curtail the volume of these issues as to render them an ineffective tool for economic development.

The enactment of TEFRA imposed restrictions on IRB's that were fairly consistent with NACO policy on small issue bonds, with the exception of the 1986 sunset provision. TEFRA also imposed depreciation restrictions generally on IRB's that NACO did not advocate, although bonds for some exempt activities were excluded from these restrictions. The effective date of most of the TEFRA limitations was January 1, 1983 and NACO believes that insufficient time has passed to evaluate their impact on total IRB volume.

It seems clear, however, that the recent volume of small-issue IRB's does not warrant imposition of additional restrictions on this type of bond. The May 1983 report of the Congressional Budget Office states that, in 1982, total small issues amounted to $12.7 billion, less than a 1 percent increase over the 1981 level of $12.6 billion. Moreover, the small-issue IRB share of the total of new long-term tax-exempt issues declined from 22 percent in 1981 to 15 percent in 1982. The Congressional Budget Office does not anticipate any significant increases in the volume of IRB issues in 1983.

The National Association of Counties, therefore, does not support the additional restrictions on small-issue IRB's contained in section 4 of H.R. 1635. These would exclude large businesses, defined as those having incurred more than $20 million in capital expenditures during the 3-year period prior to IRB issuance, from using IRB's. They would also prevent the use of IRB's by businesses or industries having more than $20 million of small-issue IRB's outstanding. They would prohibit financing of land acquisition through small-issue IRB's. NACO considers these additional restrictions to be unnecessary given the current stable volume of small issues. Also, we feel that denial of IRB financing to large businesses would be harmful to efforts by economically disadvantaged jurisdictions, such as Essex County, New Jersey, to attract development to their depressed downtown areas. Often the location of a large department store or some other large business is the key to renewal and such companies may require IRB financing as an incentive to locate in a depressed area.

Section 2 of H.R. 1635 generally would require straight line depreciation of property financed by all IRB's (with the exception of those issued to finance low-income rental housing). Thus, it would no longer permit accelerated depreciation for several categories of exempt activities as under TEFRA. It also extends the ACRS depreciation schedule. NACO does not support imposition of these restrictions on small-issue IRB's. Current NACO policy also objects to the imposition of these or any limitations on IRB's issued for exempt activities, but we will be reexamining this latter policy during our annual meeting next month in light of the significant increase in the volume of these bonds between 1981 and 1982.

With regard to section 3 of H.R. 1635, NACO does not object to prohibition of the investment of IRB proceeds in federally insured deposits. We agree that such investments place IRB's in a competitively superior position in relation to U.S. Government securities and we acknowledge that this violates established Federal policy against Federal guarantees of tax-exempt obligations.

That concludes our comments on H.R. 1635. I'd like now to comment briefly on H.R. 3110, the Government Leasing Act of 1983. It is our understanding that this bill would severely restrict the depreciation deductions and investment tax credits now available to private sector entities which either purchase and lease back to State and local governments property used by the latter, or maintain service contracts with them. NACO did not testify at hearings last week on the issue because our taxation and finance steering committee has not had an opportunity to evaluate the proposed legislation. It will be considered in detail at our annual meeting next month. Let me reiterate however, that use of sale leasebacks and other innovative financing mechanisms is a response by State and local governments to the severe fiscal pressures I earlier described. This technique can effectively reduce the borrowing cost of State and local governments by as much as 2.25 percent below that for a conventional lease revenue bond. When evaluating the appropriateness of the use of this financing technique by county governments, therefore, NACO will take into consideration the benefits of this reduced borrowing cost and attempt to safeguard the competitive borrowing position of State and local governments in relation to the private sector and the Federal Government. We will also evaluate problems that may arise for some county governments as a result of the effective date of the restrictions.

Finally, I would like to comment on H.R. 1176, which would repeal the December 31, 1983 sunset date for the issuance of mortgage revenue bonds. NACO has no policy position on this issue, which also will be considered at our annual meeting. Many counties utilize these bonds to provide mortgage funds to first time homebuyers with low and moderate incomes who could not otherwise afford to purchase a home. There has been substantial controversy over the results of the GAO study of mortgage revenue bonds' use and efficiency and we will evaluate the differing view points that have been expressed before formulating our policy.

In conclusion, I would like to state that the issue of tax-exempt financing for private purposes is one with significant intergovernmental policy implications. Perhaps the major question involved is that of who should determine what constitutes public purpose in the issuance of tax exempt debt by State and local governments. NACO's member counties believe that many so-called "private purpose" financings, such as those for housing or industrial development projects, serve a definite public purpose. Moreover, NACO members are convinced that elected State and local government officials are capable of making reasoned judgments as to what constitutes public purpose without the imposition of overly restricitive guidelines by the Federal government or congress. Although NACO shares the concern of Congress and the Federal Government regarding large Federal deficits, we fear that imposition of unreasonable controls on tax-exempt financing for private purpose projects by State and local governmenmts may hamper the ability of these governments to generate and support economic activity within their jurisdictions. Such controls ultimately may have a negative effective on the overall health of the national economy.

Thank you for providing me with an opportunity to express NACO's views to the committee on this most important issue. I'd be happy to respond to any questions you may have.

Mr. PICKLE [presiding]. Thank you, Mr. Coffey, for your testimony. And I thank all you gentlemen.

Now, first the Chair is going to take advantage of the prerogative as chairman to make a comment to Senator Howard. I certainly appreciate your testimony and I know of your support of the general industrial development bond program, particularly in its early days.

The fact of the matter is that what we designed and what we created 8 or 10 years ago is in the minds of most of our members a program that would help manufacturing concerns or an industry come into a smaller community and start a business and provide jobs. It has not worked out just that way, because, in my opinion, of the bankers and the bond lawyers who have pushed and sold these projects so much.

But no matter. Senator Howard, you were quoted in the Dallas Morning News last year as saying this:

> "The IRB's or the industrial development bond projects were supposed to create a lot of new jobs. Looking back at it now, we had a lot of projects that did not do that." Senator Howard said he still grimaces over an early $54 million loan to a project in Texas City that created only eleven jobs.

Mr. HOWARD. That is correct.

Mr. PICKLE. That cannot be much of a recommendation for a continuation of the program on that kind of a basis, and I presume that is what you are trying to stop. You want it to go forward to create jobs, but not let it be just for tax writeoff purposes. Is that basically what you are saying?

Mr. HOWARD. That is correct, Mr. Pickle. I introduced the bill that brought IRB's to Texas, because my district borders Arkansas, Lousiana and Oklahoma, and all those States had it and we did not have it and we were trying to compete with them. We felt like it would be a benefit, and we sold the package to the legislature, just like you did here, based on industrial and manufacturing and bringing jobs. And my area is basically rural. It was designed too to benefit the rural areas.

But the beneficiaries over the years have changed our statutes in Texas, and other States too, Mr. Pickle, and in my opinion it has gotten away from the initial intention of the piece of legislation that you intended and we intended in various States. And I believe that your bill is a step in the direction of doing some limiting, that will give some support and give some limitation to the proliferation that is occurring.

Because what I do not want to see occur is you all to do away with it totally, and that is what I am concerned about.

Mr. PICKLE. I did not hear that last part.

Mr. HOWARD. To do away with IRB's totally, that would be a great concern.

Mr. PICKLE. The bill that we have introduced is a restriction on the use of the bonds. I guess a comment in connection with what I am saying to you, and I would also say to Mr. Coffey, that we are not proposing to kill the industrial development bond program, but to cut back.

And Mr. Coffey observes that the volume has not gotten much bigger now in the last year since TEFRA, and there is a factual affirmation of that fact. But about all we have done with TEFRA is kept it from getting worse. The question is what do we allow?

This bill simply cuts back about 6 percent of the revenue loss, that is all, of a potential $15 billion revenue loss, say 5 years now, it would only cut out about 6 percent. Maybe we ought to go a lot further, as the Treasury testified today.

I want to assure you that this is not an effort to cut out all of the programing, but rather to make corrections on it. And Senator Howard, I will say this, that I know that you have a concern about the prohibition of using money for the purchase of land.

Mr. HOWARD. Yes, sir.

Mr. PICKLE. Originally many of us thought that that would be a good thing to allow the small rural community, but those bond houses that are trying to promote these aggie bonds have gone all across the United States and created programs. I have one here, a reprint of the Washington Post about Virginia. They passed a bill over there and they advertised it and advertised it and they only got 18 farmers coming in to take advantage of it. Very expensive program. And this is where some of the abuses are.

I want to ask that this be made a part of the record, because I want the chairman to see some of the abuses of this.

[The material referred to follows:]

[From the Washington Post, May 30, 1983]

SUBSIDIZED-FARM-LOAN PLAN FALLS FLAT IN VIRGINIA

(By Michael Isikoff)

Richmond.—A new Virginia agricultural loan program, pushed through the state legislature two years ago by a group of investment banking firms, will end up benefiting only 18 farmers in the entire state.

Conceived by New York-based brokerage firm E. F. Hutton and pushed in Richmond by a politically influential lobbyist for Wheat First Securities, the state's largest brokerage firm, the Virginia Agricultural Development Authority had been lobbied to the General Assembly as an economic shot in the arm for a depressed farm economy.

But, because of a series of actions by the Reagan administration to curb such lending programs and what critics now say were inherent flaws in the structure of the program itself, the low-interest loans offered by the authority this spring stirred little reaction in rural Virginia. The authority had planned to issue up to $25 million in federally guaranteed, tax exempt bonds, with the proceeds loaned by commercial banks to Virginia farmers at a fixed rate, below market interest rates.

But despite efforts to advertise the program at seven meetings throughout the state earlier this year, the authority could find takers for only about $1.4 million in loans.

The 18 relatively well-to-do farmers who signed up for the loans represent little more than 3 percent of the 500 farmers the authority's backers had once told lawmakers the legislation would benefit.

"This thing could have been a good thing for some folks," said James Khee, the executive director of the Virginia Agricultural Development Authority. "It was a disappointment to all of us. This thing has been one trial after another."

In part, Khee said, the low sign-up rate was caused by lack of adequate publicity resulting in relatively few of the state's 60,000 farmers even being aware of the program's existence. But there are some who question whether many farmers had any use for the loans in the first place.

As structured by the legislature, the agricultural loans could only be used to purchase new real estate and farm machinery, a largely irrelevant concern to those farmers who have been struggling with sagging grain prices. And those prosperous farmers who did want to expand could probably afford nonsubsidized commercial bank loans anyway, critics said.

"Farmers are trying to hold on to what they got right now," said Alex Hamilton, spokesman for the Virginia Farm Bureau. "The major money they're interested in borrowing is operating funds. They're not interested in more money for real estate and machinery and getting further in debt."

Nevertheless, state officials blame the bond issue's problems primarily on the Reagan administration, which has attempted to curtail the explosive growth of industrial revenue bonds (IRBs)—tax free bonds floated by state and local governments on behalf of private business concerns. Agricultural IRBs, a relatively new wrinkle in the tax-exempt bond market, were cooked up four years ago by E. F. Hutton's public finance department, which has long enjoyed a lucrative trade in the underwriting of public bond issues.

In a nationwide lobbying campaign, Hutton executives traveled from state to state, persuading 18 legislatures to create authorities empowered to float the issues. In Richmond, Walter Craigie, an influential Republican fundraiser and the executive vice president of Wheat First Securities Inc., was hired as lobbyist to steer the legislation through the General Assembly.

As it sailed through the 1981 session without dissent, legislators were clearly under the impression that the authority's loans would help a broad cross-section of Virginia agriculture.

"We thought it was an idea to help people who couldn't get money anywhere else to stay in farming," said state Sen. J. Dudley J. Emick (D-Botetourt), a member of the Senate Finance Committee, which approved the legislation. "I thought it would be available to a wide range of people."

Craigie and Hutton executives say, however, that they only sold the idea as a means of helping "younger and newer farmers" get on their feet. They do not, however, deny their own self-interest in pushing the legislation. Not long after the authority was created in 1981 and its members appointed by former Republican Gov. John Dalton, Hutton, Wheat First and Craigie Inc., an investment firm founded by Craigie's father, were selected as co-managers for its first bond issue.

In pushing the creation of the agriculture authority, "we were responding to a need [for farm loans] and what we thought was a good business opportunity," said David Seltzer, a vice president for E. F. Hutton. "There's no question that we're not a charitable organization." What Hutton hadn't counted on, however, was opposition by the Reagan administration, which has viewed the profilerating growth of tax-exempt IRBs as an inequitable allocation of credit and a multibillion-dollar drain on Treasury revenues.

"They're a distortion in the credit markets," said one Treasury official. "What you're doing is allowing private businesses to take advantage of the tax exemptions."

Early in March, the administration took its most damaging swipe at the IRB market-drafting legislation for Sen. Robert Dole (R-Kan.) that, effective April 15, would remove tax exemptions for IRBs that were guaranteed by the Federal Deposit Insurance Corp. or the Federal Savings and Loan Insurance Corp. Similar legislation had already been introduced in the House by Rep. J. J. Pickle (D-Tex.)

The mere fact that such legislation was being considered was enough to cripple the agricultural loans just as many of the state authorities, including Virginia's, were getting ready to float their first bonds. "It was a kick in the groin of all the authorities," said Seltzer.

Virginia officials, fearing that the bills might pass, rushed to meet the April 15 deadline and set a March 24 cutoff date for farmers to sign up with participating commercial banks—nearly two months earlier than the authority had originally planned. Only 32 farmers responded, and 14 of them later dropped out because they failed to meet credit tests set by commercial banks, Khee said.

The actions in Washington were also a kick in the groin for the investment bankers. The three firms had once planned to charge the state an underwriters fee of about 2.5 percent, which would have guaranteed them about $625,000 on the planned $25 million issue. But with only $1.4 million in loans and a $100,000 reserve, the offering totaled only $1.5 million, and the commission amounted to only 1.5 percent, producing $81,750 to be split amoung Hutton, Craigie and Wheat First, said William C. Boynest, an executive of Craigie Inc. "You don't make money on every deal."

Meanwhile, the question remains about how many farmers needed the agricultural loans in the first place. The loans average a little less than $100,000 per farmer and are going for such purposes as the installation of new milk parlors, hog feeders and feeding sheds, as well as for real estate purchases.

David S. Salmons, 28, of Virginia Beach, is receiving the largest loan—$241,000 at an interest rate of about 11 percent—to purchase 500 acres adjacent to his commercial hog farm.

"I could have borrowed the money somewhere else," said Salmons in a telephone interview. But, he added, he was attracted to the authority's offer of a fixed long-term interest rate, something that is no longer available in nonsubsidized commercial bank loans. "I was half scared that if I borrowed the money [from a bank] the interest rate would shoot back up to 16 percent," he said.

Another authority borrower, who asked not to be identified, was more skeptical about the program, though. This part-time farmer acknowledged that he is in no financial trouble and could have readily borrowed the money without the authority's subsidy. "But I'm going to take advantage of it if I can get it," he said.

"As far as I'm concerned this is a typical government program in that you got a bunch of politicians who sit up there and pass these things so they can run home and tell their constituents about it," the farmer added. "And it doesn't amount to a damn for anybody."

Mr. PICKLE. But we are not unsympathetic to trying to work it out so that in certain conditions we could purchase land.

Mr. HOWARD. In a small issue in a small rural community, in a small town of 2,500, 5,000, perhaps it would limit them from doing a project where—perhaps you could write it so that you would eliminate the possibility of aggie bonds, but may allow the small projects.

Mr. PICKLE. That is a possibility. That is a possibility, Senator.

Mr. Latimer, I want to say, I have visited with a representative of your city and I know you have a concern primarily with respect to leasing, more than with industrial development bonds. I do not know what we can do, but we are mindful of your concern and we will be visiting with you individuals later.

Mr. Knight, before you leave, I know you want to catch a plane. I understand that your organization, the National League of Cities, has gone on record apparently asking for the immediate termination or the termination of the industrial development bonds. Is that factually correct?

Mr. KNIGHT. A task force of the National League of Cities—this is not the National League of Cities policy at this point—a task force on municipal bonds at the National League of Cities has made that recommendation.

Mr. PICKLE. To do away with it?

Mr. KNIGHT. That would have to be taken, obviously, to——

Mr. PICKLE. That is a strong recommendation, coming from a group that has benefited from it. But it certainly does get our attention.

Mr. KNIGHT. Well, we have concluded, sir, that the cities are facing a very hostile environment today for their traditional public purpose bonds, and we realize it was a very strong statement. But in order for that to get the focus that we think is necessary, it will have to be taken to the League as a whole, and it has not been at this point.

Mr. PICKLE. Well, I read your testimony. It is very strong and I appreciate it.

Mr. CONABLE. I would like to explore that further if I can. I am sorry I missed your testimony, Mr. Knight. Do you discuss that in your testimony, the issue of whether or not——

Mr. KNIGHT. No; that is not the policy of the National League of Cities. What Congressman Pickle was alluding to was a statement or a position taken by a task force of the National League of Cities that will be recommended to a steering committee at a later date and be discussed as National League policy and be debated. But that is the position of a task force of the National League of Cities.

Mr. CONABLE. I am bemused by this whole area. It is viewed by many cities, communities, or other levels of government as a necessary, competitive tool. But if they all have it, obviously it is not really a competitive tool. If the people they are trying to benefit have access to credit themselves at a reasonable level, it does become a can of worms, if everybody is expected to issue industrial development bonds for every purpose that can be conceived by potential developers in the area.

Is that view related to the doubts that seem to be on the rise in your organization?

Mr. **Knight**. I think that would be part of it, Congressman. And again, let me tell you that that is the sentiment of a task force and not policy.

Mr. **Conable**. Yes; I understand that.

Mr. **Knight**. The task force has had the opportunity to spend some time in hearing testimony, some of the same testimony, as a matter of fact, that you are hearing here from the General Accounting Office and the Congressional Budget Office and the Treasury, from staff people in the Senate and in the Congress, and that was the decision that they made, and part of their thinking was based on what you said.

There were some other important matters that went into it, but it was also dealing specifically with small issue industrial development bonds, and we do recognize that that is a very strong statement.

Mr. **Conable**. Well, it is clear that if we continue to have a proliferation of issues of tax-exempt bonds for all purposes, public and private, without adequate restraint, it will greatly affect the capacity of cities to issue tax-exempt bonds for the more traditional capital needs related with urban operations generally.

Mr. **Knight**. Congressman, there is disagreement here this morning, or at least I perceived it as disagreement, as to what role volume plays in the marketplace. I happen to believe that excessive volume does drive up the cost in the cities' going to the bond market with this traditional public purpose debt.

We have had estimates that range from 1 basis point to 13 or 14 basis points per billion. I suppose if you do not hold to the notion that is relevant, it does not make any difference. If you hold to the notion that that does make a difference, it becomes extremely important as to the volume in that market.

And that was part of our concern. And based on the testimony I gave, we are interested in lowering the cost and increasing the marketability of our traditional public purpose debt instruments, and we feel as though private borrowing has preempted that.

Mr. **Conable**. Well, we really have a problem here in this committee trying to represent a complex of interests, including the interests of local government, in trying to find a balance that will be based on judgment and not simply on some kind of mindless pressure that you have to continue this sort of thing indefinitely and for any purpose.

Mr. **Knight**. My observation is this is not unlike the city commission chambers of the city of Wichita, Kans., in terms of divergent opinions, and I would think it would probably be more typical than atypical of many communities and other levels of government in this country. This is a highly charged issue.

Mr. **Conable**. Thank you very much. I appreciate the answers.

Mr. **Shannon** [presiding]. Mr. Frenzel.

Mr. **Frenzel**. Thank you, Mr. Chairman.

Mr. Knight, you presented testimony from the National League of Cities indicating that you oppose Mr. Downey's and my bill and would like substantial change if it were passed. However, other representatives of other cities and other State units of cities have indicated that they think it is a good idea.

Is it fair to say that there is some diversity of opinion among municipalities throughout this country?

Mr. **Knight**. Congressman, I just indicated to Congressman Conable that not only is there divergent opinion among cities, there is divergent opinion in my own city. I think it is that type of issue. It is a difficult issue and I think that expecting you to reconcile that to everyone's satisfaction is going to be impossible.

What I have tried to relate to you is the opinion and policy of the National League of Cities. To answer your question, yes.

Mr. **Frenzel**. Thank you, Commissioner. I appreciate that.

Senator Howard, I note that in Texas your IDB legislation was a matter of self-defense against Louisiana and Arkansas. When I was a member of the National Conference of State Legislators, I was the author of the Minnesota legislation for IDB's, and it was also a matter of self-defense. All our industries were being pirated by all of you thoughtful southerners who were smarter than we were and put such legislation on the books.

We now have a sort of an impasse, and one wonders if the only beneficiaries are the bond houses and the only losers are the taxpayers.

But be that as it may, I have a question about the suggestion which was made here earlier and to which you referred in your testimony. What happens if you use a trigger, an interest rate trigger for mortgage revenue bonds, or I suppose for IDB's as well? Is it not true that the unevenness of mortgage rates across the United States would make it pretty difficult to plan? And would you not have to open an office and close an office and begin a program and close a program down?

Would you comment on that, please?

Mr. **Howard**. Yes, Congressman. I do not have—I would not be able to speak for the conference because I do not know their views on that. I would have to express, I guess——

Mr. **Frenzel**. But Sam and Jake have already certified that you are the smartest thing in Christendom.

Mr. **Howard**. Unfortunately, Congressman Hall is one of my constituents, and rumors that I am running against him are not correct.

Mr. **Frenzel**. I am glad you cleared that up.

Mr. **Howard**. I have cleared that up with the Congressman, too.

But perhaps a triggering mechanism could be put into place that could be of benefit, Congressman. I guess my greatest concern deals with, I do not know how you stop the proliferation. I do not know how you keep it from going into projects. You all did some good things when you limited the type of food industry type things, but a further limitation really has to be done, Congressman. I am not sure I can answer you specifically on that.

Mr. **Frenzel**. Then may I refer to Mayor Latimer. What is your opinion of a triggering mechanism as a limitation? Would that inflict chaos or would it be a reasonable limitation?

Mr. **Latimer**. Can you, Mr. Chairman, Mr. Frenzel—triggering mechanism by volume or——

Mr. **Frenzel**. No; this morning one witness and several members of the panel suggested that we have mortgage revenue bonds specifically subject to a trigger. That is, if interest rates got below 9 percent or something, that it would automatically cancel, and if they got above 9 percent it would automatically trigger in the mortgage revenue bond scheme.

And a point was made that it would be difficult for planning for local HRA's and State housing finance agencies.

Mr. Latimer. Mr. Chairman, thank you for clarifying it. I think that for housing development purposes some kind of trigger with proper advance notice might have a good deal of merit. I think for other areas where long, long-term planning is needed, it might be a little bit tricky.

May I use this to expand a little bit on both your and Congressman Conable's point about the competitive quality of the use of revenue bonding? Several points I would like to make. No. 1, by definition this authority is a localized authority. Therefore, if we are going to be seeking greater self-reliance and creativity at a local level, it seems to me that revenue bonding as one tool is very valuable.

Second and probably more important from the standpoint of, are we creating or are we replacing or competing, the vast amount of our $100 million of revenue bonds in the past year or two with the port authority have created or expanded small business. That has been the overwhelming number, have been small units of business with small issues, that combined have been able to expand during a difficult time with interest rates.

I think that is valuable to the country and it is more valuable than simply to let us compete better against another portion of the country, or indeed against a neighboring State, but carries with it some intrinsic job-producing opportunities. So we have small energy-conserving companies that have been started lately. We have a small steel plant. I do not know how many new steel plants there are going on in this country, but we have a new steel processing plant about 3 years ago, using revenue bonding.

So I do think it is more than just transferring jobs from one region of the country to the other, and it is in fact a very important part of local creativity. So I think that is the reason for continued support of IDB's.

Mr. Frenzel. Thank you very much, Mr. Mayor.

May I ask one further question of you, as mayor of the city of St. Paul rather than as representing others? You have a project, or more than one project, in the city which involves the leaseback operation, and as I understand, your desire with respect to the Pickle bill is that those municipalities and agencies who have made plans and have spread their projects on the record and have gone forward with them be permitted to carry them out, and that the bill be prospective rather than retrospective in its effect.

And I think that is what Chairman Pickle and I had in mind when we introduced the bill. But do I state your position correctly?

Mr. Latimer. You do it beautifully, Mr. Chairman and Mr. Frenzel. To put it plainly, we do seek mercy and not justice on this issue. And I speak for myself and my city, which is what I am paid to do. And that is not why I am here today, of course. It is the legislation that is separate from this.

But absolutely, I personally am not prepared to separate myself from the effort you are making to take better control of the sale-leaseback. I think it has got to be done. But I do think we made a good faith effort and did it with full hearings and with a fairly restrained approach to the projects needs, creating jobs for this summer, to use existing law. And for that I ask mercy and an extension of time so that we can get on with our work.

Mr. **Frenzel**. Thank you.

I think that is what we had in mind, and I hope the committee will carry it out.

Thank you.

Mr. **Shannon**. Thank you all for your testimony.

The next panel is Lt. Gov. John Kerry from Massachusetts, Mr. Myron Louik, Mr. Chip Morgan, and Mr. Ramsay Potts.

Gentlemen, all of your statements will be submitted for the record in full form if you do choose to shorten them.

Let me welcome you all, but particularly let me welcome Lieutenant Governor Kerry. It is a pleasure to have you here, Governor. I just want to make it perfectly clear to you that they only let me chair when we are having hearings. When we actually write the bill, I will be sitting back down there. If you would like to proceed with your statement.

STATEMENT OF HON. JOHN F. KERRY, LIEUTENANT GOVERNOR, COMMONWEALTH OF MASSACHUSETTS

Mr. **Kerry**. Thank you, Mr. Chairman, very much, and members of the committee. I am delighted to be here.

You have a copy of my written testimony, and I would like to just summarize a couple of points, if I may, from that.

Massachusetts is extremely concerned about the potential for the loss of IDB's. We feel that the program that we have had in place which Governor Dukakis began in 1978 has been one of the most successful in the country. We would readily admit that there have been occasions when perhaps there have been issuance of bonds where one might think they should not have occurred and even some relocations which we might say should not have occurred. But I think all in all the bottom line is that these have been absolutely essential at a very difficult time in this country's economic fabric where we have been able to not only survive but to grow and to continue to have an unemployment rate that has been lower than the mean in this country.

And it is our feeling that the current proposals, those restrictions that are being put forward would seriously reduce our capacity to continue the rate of economic development that we have had.

Since 1980 alone about I think it is 18 million square feet of space have been put in. It is half the amount that the State has put in during the entire period of time without IDB's. We have had about 1,236 projects in all, close to $2 billion invested of that, and I think that this is particularly significant in terms of some of the concerns of the committee.

One-third of the companies receiving these IDB's were founded since 1970. Over one-half had less than $5 million in sales, and four out of five had sales of less than $20 million. In addition, two out of every three employed less than a hundred people.

We recently had a study done which was certified by Coopers and Lybrand which showed that even if you discounted by some 70 percent the numbers of jobs that were claimed to have been created by those IDB's, you still wind up with about 63,000 permanent new jobs in the Commonwealth of Massachusetts. So we believe that it is a very, very important process which is critical to having investment where it might not otherwise take place.

Let me just close by saying that I think there is a much bigger picture that we ought to consider also before the baby gets thrown out with the bathwater, and that is that as we increasingly become a global marketplace, many of our industries in Massachusetts are high technology. We are competing not just with other States, but obviously with the world. Seventy percent of our goods are in competition with other nations.

And time and again I hear it and the Governor hears it, there are businessmen who are opening companies in Brazil or a host of other countries because they can afford to do business there.

We must maintain a competitive edge. And at a time of high interest rates, it seems to us that one of the only ways we can do that, whether it is in capital formation or in operating and maintenance or any other kinds of costs, is through this kind of government incentive, government kick, if you will, to be able to invest where otherwise those investments might not take place.

And I will just close by saying we also did a study under the auspices of the University of Massachusetts which showed that fully 85 percent of those new issuances of bonds that I talked about, those business decisions would have been made otherwise, either canceled or delayed or drastically reduced because of the cost of doing business and the cost of money.

So we strongly urge you, and we hope that you will refrain from restrictions that would, in effect, gut our capacity to continue this program.

Thank you very much.

[The prepared statement follows:]

STATEMENT OF LT. GOV. JOHN F. KERRY, COMMONWEALTH OF MASSACHUSETTS

Mr. Chairman, members of the Committee: I am appearing before you today because I am concerned about not only the economy of Massachusetts, but that of the entire nation, and the many challenges that lie ahead.

We, as a nation, have learned a painful lesson by failing to maintain a competitive edge in many of our most important traditional industries—from textiles in the Northeast to automobiles and steel in the midwest. We have learned that we must continually modernize through investment in productive assets such as plant and equipment. And we have learned that to some degree we are subject to international and national market forces over which we have little control.

Last year Congress enacted a series of provisions to reform the industrial development bond program as part of TEFRA that are designed to eliminate specific abuses of this important program. The reforms preserved the bonds for critical job-creating expansions for smaller businesses. Congress directly eliminated past abuses of the program while subjecting each IDB issue to public scrutiny through public hearing requirements and approval from the highest elected official in the project's jurisdiction. A 1986 IDB sunset provision was also adopted.

House bill 1635 contains many of the same provisions last year proposed by the U.S. Treasury which would all but eliminate IDBs by stretching out depreciation schedules on productive investments. To adopt further restrictions without giving those enacted last year an opportunity to work would be a critical mistake considering the state of our economy. Further provisions would only choke off reasonably-priced capital for productive investments.

IDB'S IN MASSACHUSETTS

IDBs have played a tremendous rule in the revival of the Massachusetts economy over this last few years. Much of our success during the past recession has been sparked by the growth of smaller, innovative enterprises that are expanding their operations and adding new jobs. To reach their full potential and remain competitive, these smaller companies have needed to invest in large and efficient plant space as well as modern equipment.

But over the past few years these promising companies have faced the highest real interest rates in our country's history. And real interest rates today remain burdensome and even seem to be rising.

Moreover, in Massachusetts IDBs have proven essential in convincing developers to invest in downtown areas in Massachusetts. Through a careful targeting program for commercial projects using IDBs, we have been able to stimulate $275 million of investment in downtown areas.

Finally, by successfully leveraging investment, IDBs create thousands of jobs as well as important construction work.

With severe budget cuts in every other federal economic development program, industrial development bonds are the only effective financing mechanism to cut borrowing costs. Repealing or curbing IDBs at this time would serve only to raise interest rates further for smaller businesses investing in plant and equipment. These are exactly the types of investments we should now be encouraging.

Four and one-half years ago Governor Dukakis of Massachusetts created the Massachusetts Industrial Finance Agency to administer IDBs in our state. It has become one of the biggest achievements of his first administration.

MIFA, as we refer to this agency, has assisted the expansions of 1,236 industrial companies and targeted downtown revitalization projects with nearly $2 billion in financing. Since 1980, this agency has helped companies to add 18 million square feet of new industrial space in the Commonwealth, half of all such space added in the state during this period.

These expansions will result in an estimated 63,000 new, permanent jobs, and 25,000 man-years of construction work.

Most of this assistance aided smaller businesses. Two out of three companies receiving financing last year had less than 100 employees in the state; over half had sales of less than $5 million; and one-third had been founded just since 1970.

Were IDBs essential to the investment decisions of these firms? According to a 1981 survey of IDB users in Massachusetts, 85 percent would have been forced to either reduce or cancel their expansions had IDBs not been available. More specifically, one-third of the companies would have scrapped their investments completely, another third would have indefinitely postponed their plans, and one-fifth would have reduced the size of their investments by more than 40 percent.

A 1982 University of Massachusetts economic analysis of the state's IDB program shows that personal income will rise by $6.5 billion and federal and state tax revenues will rise by $1.3 billion over the next decade as a result of jobs generated from IDBs issued from 1979 to 1981. This conservative study even discounted 70 percent of the jobs actually credited to the program, arguing that these might have been created even if the bonds had not been available. Nevertheless, the impact on our economy is still enormous.

H.R. 1635 AND H.R. 3110

Both House bills 1635 and 3110 would jeopardize the future growth of the Massachusetts economy by choking off affordable expansion capital to smaller, innovative companies and urban revitalization projects.

H.R. 1635 presents a serious disincentive to companies prepared to expand their operations by forcing them to choose between IDBs and ACRS depreciation schedules. To my mind we must forge an economic policy that encourages productive, job-creating investment. In a time of high interest rates, this provision would serve only to discourage modernization.

Secondly, H.R. 3110 would handicap our efforts to save nationally significant historic buildings by eliminating favorable tax credits when the rehabilitation of these structures is financed with IDBs.

Massachusetts has used IDBs effectively in our older urban areas to rehabilitate these buildings which are so much a part of our cultural heritage. IDBs have been targeted to our distressed downtown areas where they have helped 172 revitalization projects with $275 million, the majority being renovation projects for older buildings.

Massachusetts has rehabilitated 17 million square feet of space in older, existing structures using IDBs combined with federal tax credits designed to preserve our cultural heritage through preservation. This financing arrangement has been critical to the success of hundreds of productive developments in our state, but I would like to focus on one in particular.

The historic Spalding Mill Complex in the city of Chicopee, Massachusetts was the home of a weapons manufacturer in the late 1800's, and was later used as manufacturing plant for the Spalding sporting goods company. The company needed more efficient space to compete and moved to another location in Chicopee, leaving behind the 120 year-old mill complex. Using a $4.5 million IDB, historic tax credits, and a $1.5 million U.D.A.G., investors will soon rehabilitate this 190,000 square foot complex and convert it into 138 rental housing units with 11,000 square feet of commerical space. Fifteen to twenty percent of those units are reserved for low and moderate income residents.

This worthwhile project, like many others now underway across Massachusetts, would be stopped in its tracks through passage of the investment tax credit provision in H.R. 3110. This provision discriminates against rehabilitation of historic buildings in favor of new construction, and also against older regions of our country attempting to revive their urban heritage.

RESERVE IDBS TO REDUCE COST OF CAPITAL

I urge the Ways and Means Committee to defer action on further restrictions to the IDB program. Responsible reforms were enacted just last year, and the 1986 sunset will give Congress an adequate opportunity to review the program and then make appropriate changes based on accurate data from new reporting requirements. In fact, if ever IDBs were needed, it is now.

With millions of able citizens out of work, and with the economy just now emerging from a devastating recession, it would be foolhearty to cripple a proven economic development tool. IDBs create jobs and stimulate productive investment, which the 1981 Congressional Budget Office report said resulted in jobs and additional state, local and federal tax revenues.

For example, the CBO report estimated that increased investment from IDBs will generate over $4 billion of additional GNP in 1986, including $2.2 billion of increased wages and salaries. This is enough to employ 150,000 people at an average wage of $15,000 per year. Since the CBO places the true cost of IDBs in 1986 at $800 million, the CBO's own numbers make IDBs the federal government's cheapest employment-producing program at $5,300 per job.

I began my testimony by discussing the realities of today's global economy, and it is clear that we must improve our competitive posture in order ensure future prosperity and economic growth.

A recent study directed by George N. Hatsopoulos, founder of Thermo Electron Corporation in Waltham, Massachusetts and an IDB recipient, shows that the cost of capital is nearly as great a competitive disadvantage as the widely publicized higher labor costs. Mr. Hatsopoulos concluded that, "U.S. business faces an almost insurmountable barrier—a cost of capital nearly three times that of their Japanese competitors."

In Masachusetts IDBs have greatly assisted the high technology industry, providing low interest financing for 253 job-creating, technology-related companies. Over 18,000 new, permanent jobs will result from these expansions.

If we are to maintain our lead in high tehcnology pursuits over aggressive foreign competitors, then we must take Mr. Hatsopoulos' advice and lower the cost of capital for growing companies that are improving their operations and investing in research and development. Just like our products, the price of our capital must be competitive with that available in other countries.

This is the purpose of Industrial Development Bonds, to cut the cost of capital for successful, growing companies that are investing in productive assets and creating new jobs. Considering this country's current disadvantage of highly priced capital, it makes no sense to eliminate a program that effectively cuts borrowing costs.

Passage of the IDB provisions in H.R. 1635 and H.R. 3110 would serve only to raise interest rates on capital investment, and this is a result we cannot now afford.

Mr. SHANNON. Thank you very much, Mr. Kerry.

Mr. Louik, would you like to proceed?

STATEMENT OF MYRON LOUIK, DEPUTY COMMISSIONER, CHICAGO ECONOMIC DEVELOPMENT DEPARTMENT, ON BEHALF OF THE NATIONAL COUNCIL FOR URBAN ECONOMIC DEVELOPMENT

Mr. LOUIK. Thank you, Mr. Chairman.

My name is Myron Louik. I am deputy commissioner of economic development for the city of Chicago, and I am here representing the National Council for Urban Economic Development, CUED.

CUED represents more than over 1,500 members in both public and private sectors who are economic development practitioners in over 400 cities in this country.

Our concern is for the industrial revenue bond/industrial development bond programs because of their usefulness as a tool for economic development helping to stimulate new private investment and creating jobs, and in many cases retaining jobs which would otherwise be lost.

Let me just comment briefly on some of the issues raised by H.R. 1635. First, we do have the recently enacted TEFRA reporting requirements, public hearings, and official approvals that hopefully will address some of the abuses that have occurred with revenue bonds. We feel that it is important to at least take a look and see what the effect of these TEFRA changes are before making wholesale changes in revenue bonds.

The second issue regarding H.R. 1635 is its prohibition of the use of bonds for the purchase of land. Using my Chicago experience, over 85 percent of the bonds that we have issued have been utilized, or at least some portion of them has been utilized, in the land cost portion of a project. Many smaller firms that would be otherwise unable to obtain financing on the site have been able to do their projects with the use of revenue bonds. In a city like Chicago, where land costs are a very considerable portion of a project, the ability to finance them through revenue bonds is key.

Third, the restriction of industrial revenue bonds to companies with capital expenditures of less than $20 million during the preceding 3 years, this would also be a very difficult type of restriction on their use in a city like Chicago.

Many of our companies, although they are small in number of employees, are very capital intensive. They may have one or two plants located across the country, and to use a $20 million limitation would be very prohibitive. For example, 88 percent of all the bonds we have issued have been to companies with fewer than 250 employees, 43 percent for less than a hundred employees. Yet, a considerable number of all those companies would not have been able to issue bonds with the $20 million restriction.

In addition, Chicago, like many other cities, has embarked on attracting the growing, new high technology companies. High technology companies are especially capital intensive, and these types of restrictions would most likely severely handicap the use of IDB's by even the very smallest of them.

Fourth, the use of an extended straight line recovery period goes beyond efforts to try to equalize some of the tax losses in terms by actually penalizing the company for the use of the industrial revenue bonds. Again, we feel that this would be very limiting to new ventures, and especially high tech ventures.

Finally, let me just conclude by urging you to take a look at the profile that we have done of IDB issues in Chicago. And I think it is important that again you look at this whole picture, and not just one abuse here or there.

Just to give a brief profile of over about 105 issues that we have done, a typical company has about 100 employees, has a single factory, has been engaged in the process of renovating or building; and has purchased new equipment. And after the project—I might note these are figures that have been obtained after the close of a project because we do monitor our projects—there has been a 29-percent increase in employment; 58 percent of the new jobs created have gone to minorities. Over half of those jobs paid over $7 an hour, and only 5 percent have paid less than $4 an hour.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF MYRON LOUIK, DEPUTY COMMISSIONER OF THE CHICAGO ECONOMIC DEVELOPMENT DEPARTMENT AND MEMBER, NATIONAL COUNCIL FOR URBAN ECONOMIC DEVELOPMENT

Mr. Chairman and members of the committee: On behalf of the National Council for Urban Economic Development (CUED), it is a pleasure to be here today to discuss the importance of industrial development bonds (IDBs) in urban econimic development, and to bring our views on IDBs as a development tool, as well as specific comments on HR 1635, to the attention of the Committee. To the more than 1500 public and private sector CUED members who plan and implement a wide variety of commercial and industrial projects in more than 400 cities around the country, IDBs are a vital tool for stimulating private employment and investment in areas that critically need them.

The importance of IDBs to revitalization efforts in many areas which have experienced long-term disinvestment can not be overemphasized. The availability of IDBs has been the principal cause of new business ventures and the expansion of existing ones in numerous localities. In an era of high interest costs and shrinkage in federal program assistance, IDBs have been crucial to the founding and growth of business enterprises in many urban areas. At the same time, we at CUED have recognized that IDB abuses have occurred, and have worked towards ensuring a better and more efficient use of the IDB incentives.

JUSTIFICATION FOR IDB'S

A comparison of the cost of IDBs as a capital investment subsidy to their cost in tax expenditures to the Federal Treasury is not complete, however, until the value of the capital subsidy to private firms is weighed against the number of new jobs and extent of private investment that the subsidy generates. In many cities, economic growth sufficiently compensates for any lost federal tax revenues.

In Chicago, last year alone we closed more than $40 million in tax-exempt financing for a wide variety of industrial and commercial projects. The City of Chicago's IDB program has been available since 1977. During that time, over 100 IDBs have been issued, representing almost $200 million in new private investment. They are expected to create 7,333 new jobs and retain over 16,000 others.

For example, in 1982 the Union Special Corporation, a leading manufacturer of specialized industrial sewing machines, received approval of IDB financing for $2.5 million to renovate their facility in a redevelopment area of the city. The renovation enabled the company to retain 500 employees—500 jobs which would have been lost to a suburban location if IDB financing had not been available.

In Chicago, IDBs have primarily been utilized for manufacturing, assembly, and warehouse type projects. Commercial projects that have been approved include businesses that will undertake new construction in designated areas of Chicago. IDBs have also been utilized for companies that have requested relocation assistance due to a city condemnation action. Finally, IDBs have been approved to provide assistance to minority-owned companies. The Economic Development Commission has adopted a policy that will allow for commercial projects to be approved after the submission of a neighborhood impact statement which addresses the needs of the community and identifies the impacts, both positive and negative, that the project will have upon that neighborhood and other nearby businesses.

Job creation is one of the highest priorities of the Congress and the Administration. IDBs have had a substantial impact on job creation in cities around the country which have used this tool for economic development. In Chicago last year, the 26 firms which were assisted with IDBs can be expected to create 1,290 jobs and retain 2,119 others. Considerable unsubsidized spin-off development, private investment, and job creation can also be traced to the IDB activity. Furthermore, IDBs—when properly targeted by cities—can be one of the most effective tools for job creation in areas of a city which have suffered decades of high unemployment, low investment, or disinvestment.

IDB assistance has had a sizable impact on Chicago's economic climate. Many of these projects would have had to have been scaled back without this assistance, resulting in a lesser amount of private investment, reduced tax revenues to the city, and fewer jobs. Some, like the Union Special Corporation project cited above, probably would have never happened.

NATURE OF ECONOMIC DEVELOPMENT AND THE ROLE OF IDB'S

IDB financing has become an increasingly important economic development tool. In Chicago and many other cities, IDBs have been combined with other public and private sources of financing for industrial parks, neighborhood revitalization, and downtown development projects. These seemingly diverse activities are linked by a common thread—they are elements in a local economic development strategy designed to attract the private investment and create the jobs necessary to cope with economic change and its concomitant problems. Dealing with economic change is the most critical problem facing many communities—adjusting from an existing, often outmoded economic base to a new, productive one which has the financial, physical, and organizational ability to sustain economic growth.

This adjustment from one set of economic activities to another is economic development. It is not, as some have argued, a zero-sum game of using public dollars or incentives to attract existing businesses and jobs from one area to another. Long ago, we learned that such "smokestack chasing" was not cost-effective and, in some cases, counterproductive. What are needed, and what both direct and indirect federal assistance can encourage, are new jobs, new investment, and new companies to revitalize distressed areas.

For economic development to occur, whether it be a single commercial project, an industrial park, or an entire city or region, the "environment" must be conducive to investment. The components of this environment—each of which must be present for development to take place—include: Affordable capital; available developable land or space at a competitive price; infrastructure and other supportive services; tax climate conducive to investment; suitably trained workforce; and public sector capacity to assist development.

Areas facing economic decline are lacking at least one of these investment prerequisites. No one federal program or initiative addresses all of these economic development needs. But of them, capital is one of the most difficult to satisfy. IDB financing has been an increasingly important development component because of its affordability, and more sought after due to decreases in other forms of federal capital assistance. In recent years, the cost of capital has been prohibitive to many firms which were considering plant or equipment investments. The difference in interest rates between tax-exempt and conventional financing in Chicago has been as great as eight points; currently, it is about five points. Without this source of affordable capital, the development efforts of the public and private sectors in numerous cities over the last few years would have been hindered. The role of IDBs in furthering economic development is substantial.

COMMENTS ON H.R. 1635

The advantages of IDBs as a source of low cost capital are its simplicity and flexibility. Unlike many existing tools for business development, IDBs can be used in a variety of ways to meet local development needs and conditions.

Unfortunately, the very strengths of IDBs, namely, local discretion and flexibility, opened the way for their greatest absues. However, the most serious of these were addressed in the 1982 tax act. TEFRA required bond issue reporting as well as public hearings and authorization by local elected officials. These new requirements built in to the IDB system mechanisms for accountability which only now are taking effect. In general, therefore, we at CUED would urge the Committee to scrutinize any further restrictions to ensure that they do not limit the legitimate uses of IDBs.

Older cities throughout the nation are struggling with problems of outdated infrastructure distressed industrial areas, disinvestment and the constant threat of the loss of jobs. Chicago is no exception. Chicago is struggling to revitalize its industrial areas—to reverse the flow of jobs from the city. We have had some success—largely due to the availability of IDB financing. Chicago's ability to offer attractive incentives for investment and reinvestment has been essential to this revitalization effort. To limit the availability of IDBs would seriously limit the city's revitalization efforts.

As currently administered, Chicago's IDB program provides attractive incentives for the reuse of older facilities—often in economically distressed areas—providing more jobs (generally to minority employers) at higher salaries. (See Attachment A).

I would like to focus the remainder of my remarks on three proposed restrictions in H.R. 1635, and the issues which they raise.

Prohibition of small issue proceeds for land acquisition.—This could prove to be a severe constraint on business investment, especially for promising smaller firms which are not able to obtain affordable site financing. Since the availability of suitable land is one of the key requisites of economic development, this feature will sharply reduce the ability of cities to spur such development within their borders. In many cases, the cost of land offering the necessary infrastructure capacity or transportation access will be out of the reach of interested companies without some sort of assistance. The IDB tool has proven to be particularly valuable for this purpose.

If a provision forbidding land acquisition with IDB proceeds is adopted, then many of the companies seeking IDB assistance will be able to locate only on property which a city already owns—with more compatible, appropriate, and properly equipped sites in industrial parks, adjoining ports, etc., excluded from consideration. It would diminish much of a locality's potential for economic growth achieved by assisting firms through IDBs, since companies would be limited to activities suited to the city's own land inventory. Very likely, companies would be forced to locations where land was cheaper—in most cases, seeking suburban rather than central city sites.

Over 85 percent of the IDBs issued in the city of Chicago involve land and building acquisition or construction. Many companies have been encouraged to remain or relocate within Chicago because they were able to finance the entire cost of acquisition—site as well as structure—through the IDB. Without the ability to finance the land costs through Chicago's IDB program, these companies might well have had to go to surrounding areas where the land cost is not as high as it is in the city.

A restriction on the acquisition of land as H.R. 1635 proposes would seriously restrict Chicago's ability to attract and retain businesses.

Restriction of small issue IDBs to firms, including subsidiaries, with total worldwide capital expenditures of less than $20 million during the three years prior to issuance, and for whom no more than $20 million in small issue IDBs would be outstanding.—This is an important issue for a number of reasons. First, many legitimate small subsidiaries of larger firms—which have the potential for tremendously improving the economic climate in the areas in which they locate—will be shut out of the market. Expansion into a new region, which otherwise would not occur given higher conventional financing, can be encouraged.

Second, many smaller companies have made considerable capital investments which would disqualify them from IDB assistance this is particularly true for new industries providing technologically innovative products.

Over 88 percent of the IDBs issued by the City of Chicago benefit companies with fewer than 250 employees. 43 percent have gone to companies with less than 100 employees. There is no question that these growing small and middle-sized companies benefit most from these bonds and in turn provide the majority of the new jobs created. Many of these smaller businesses, however, exceed the $20 million capital expenditure limit proposed by HR 1635. We see in Chicago, for example, more and more capital intensive high technology companies whose expenditures easily exceed this proposed limitation.

Third, many cities which have used IDBs as an integral part of an economic revitalization strategy have found that, in order to trigger new investment in a highly distressed area, one or two large "pioneers" are needed to initiate the private development process. Once these larger anchors are established, a climate for smaller auxiliary and support businesses can result. Thus, an absolute $20 million limit on firm size would severely undermine a very constructive use of IDBs.

Just a small percentage of Chicago's IDBs are issued to larger companies, but we have been able to attract their investment into Chicago's economically disadvantaged areas through the use of IDBs. Homemakers, Inc. and National Can Corporation would not have chosen to expand their operations in distressed neighborhoods without the availability of tax-exempt financing. As a result of their commitment, 225 new jobs created in economically distressed areas of the city. Because of the available incentives, these larger companies are willing to take the risk of development in an underdeveloped area—a risk smaller companies are unlikely to take.

Finally, with the extensive public review and approval procedures put into place in TEFRA, concerns over size and use can be effectively dealt with at the local level.

The addition of an extended straight line cost recovery period for IDB-financed assets.—This provision may prove to be a considerable obstacle to capital investment. While there is an understandable concern about extreme tax subsidies, this provision goes beyond tax expenditure equalization to penalizing companies which use IDB financing. Many cities have used this form of assistance to attract growing high technology firms—companies whose investment in computers, data processing systems, and other equipment will be obsolete even under ACRS terms. This detrimental effect is not limited to high tech firms. Such a limitation will also hinder the rate of industrial retooling necessary for improving the competitive posture of domestic companies with respect to foreign products. Extended straight line depreciation may close off some of the most promising growth avenues to cities seeking to nurture economic growth in a way which best helps their citizens and enhances their own futures. There are other ways of ensuring the responsible and legitimate use of IDBs—careful local scrutiny of jobs and revenue impact, the public and political approval processes, reporting requirements, and so on.

In Chicago, 52 percent of the IDBs issued to companies involve the purchase of new or renewed equipment. 85 percent of the IDBs involved the purchase or construction of a depreciable building structure. Thus, limitations of the depreciation advantage would remove an important incentive presently available through IDB financing.

CONCLUSION

IBDs are an important state and local government financing tool for capital formation, and can serve to satisfy some of the requirements for economic growth. Given the growing scarcity of federal, state, and local resources for economic development, IDBs are likely to become one of the very few methods by which scarce credit can be directed to firms suffering from high money costs, and within distressed areas experiencing severe capital shortages.

Both Congress and the Administration have asked other levels of government to take on increased responsibilities for community and economic development. We at the local level are certainly willing, but we need the tools to do the job and the flexibility to use them properly.

This concludes my statement. I will be glad to answer any questions that you may have.

ATTACHMENT A

PROFILE OF A TYPICAL CHICAGO INDUSTRIAL DEVELOPMENT BOND RECIPIENT

Chicago bond projects typically assist a small manufacturing firm of about 100 employees, which has a single facility.

The bond financing is used to renovate an existing industrial building and furnish it with new equipment.

About one-half of the project involves the renovation of buildings already owned by the firm, and one-half involves the renovation of buildings purchased as part of the project. As a consequence, only about one-half of the projects involve relocation.

In addition to the modernization of industrial plants and equipment, the employment impact of these projects is substantial. Firms with completed projects have increased their workforce by 29 percent above the level at the time of their application. By the end of the third year following project completion, employment is expected to increase an additional 36 percent above current levels.

Most jobs—58 percent—are held by minority workers. This is ten percentage points above the share of city-wide employment represented by minority workers. These are substantial jobs. Over one-half of the jobs created pay over $47.00 per hour; less than 5 percent pay less than $4.00 per hour.

Mr. **SHANNON**. Thank you very much.

Mr. Morgan.

STATEMENT OF CHIP MORGAN, CHAIRMAN, LEGISLATIVE AFFAIRS, SOUTHERN INDUSTRIAL DEVELOPMENT COUNCIL AND EXECUTIVE VICE PRESIDENT, DELTA COUNCIL, ON BEHALF OF THE NATIONAL COALITION TO PRESERVE IDB'S

Mr. MORGAN. Thank you, Mr. Chairman.

My name is Chip Morgan. I am representing the Southern Industrial Development Council and numerous other development organizations throughout a 17-State area. I am executive vice president of Delta Council, a nonprofit area development organization supported by private businessmen and farmers.

Delta Council operates a department which works full-time with businessmen and private enterprise in an effort to stimulate business and industrial development for the creation of new and better jobs for the people in our State of Mississippi.

I am interested in industrial development bond financing for one sole purpose. Our area of rural northwest Mississippi is one of the poorest sections of the country, and we need industrial revenue bonds to help finance developments that absolutely would not occur without these bonds.

For the past decade the Federal Government has been extremely conscious of the need to stimulate a national economy which has been creating hardship on the American public through high unemployment and poverty. In our area of Mississippi representing a geographical area similar to that of the State of Maryland with a population of almost one-half million people, we have been struggling with this same problem for the span of everyone's lifetime in this room.

Today, 1983, the personal income and per capita income of this large area is slightly above one-half of that of the U.S. average for per capita income, and recent data shows that almost one-half of the people in our area derive their major source of personal income from transfer payments.

We know what it means to be struggling for a viable economy and a better future for the people of our area. On the brighter side of our picture, we have experienced a healthy rate of growth in our area during the past 25 years. More than 300 industries have come to the area, creating payrolls in excess of $500 million annually. There are now approximately 45,000 more people working in our area than were 25 years ago as a result of industrial revenue bond financed facilities.

Since 1980, when the House Ways and Means Oversight Subcommittee first addressed the issue of industrial bonds, we have been working aggressively to inform Members of our congressional delegation in Mississippi of the essential nature of this business financing tool.

I know of no other example of a Government program or Federal incentive that has been offered to businessmen which has been more successful in addressing unemployment and poverty. Still, we hear the industrial development bond critics say that industrial development bonds crowd out the municipal bond market, as we have heard here today. Also, it crowds out things such as city improvements.

We hear the industrial bond critics say that industrial development bonds cost the Treasury of the United States by increasing the amount of tax-exempt financing in circulation. As for that argument that the increased volume of industrial development bonds reduces the interest rate spread between tax-exempt bonds and taxable bonds, many financial experts disagree. In fact, in 1975, bond volume was $30 billion and, by 1982, the volume had grown to $85 billion. Even considering a factor of inflation throughout this period, this growth represents a 55-percent increase in volume of bonds issued. However, during the same period of this growth in volume of bonds, the interest rate on municipal tax-exempt bonds went only from 78 percent of taxable bonds rates to 79 percent of the rate on taxable bonds.

Those who argue that industrial bonds cause municipal bonds to suffer from an overcrowded bond market should look back in history. The worst tax-exempt bond rates occurred in 1958 when tax-exempt interest rates reached 94 percent of taxable bonds. At that time industrial development bond volume was only $7.8 billion, hardly an amount of any great significance.

Mr. SHANNON. Forgive me for interrupting you. We are going to have to recess for about 5 minutes while I catch this vote, but it should not be any longer than 5 minutes.

[Recess.]

Mr. SHANNON. Perhaps we can proceed.

Mr. Morgan, do you want to finish your statement?

Mr. MORGAN. Yes, sir.

The other major argument of the industrial development bond critics seems to be that industrial development bonds cost the Federal Treasury and are an inefficient subsidy when compared to other direct Government spending programs.

We take issue with that argument on both points. First, we have hard data that shows that payroll taxes alone generated by jobs created in industrial development bond financed facilities paid the Federal debt on the tax exemption offered by Government.

In addressing the claim that industrial development bonds are an inefficient subsidy, may I ask you as a committee what could be more reasonable or financially responsible than for the Government of the United States to provide the financial tools to local governments whereby they can assist in the orderly growth and development of job opportunities that may not otherwise be provided.

While we contend that industrial bonds are irreplaceable insofar as a Government program for encouraging investments that result in new jobs, the meaning of industrial development bonds goes further in striking at the heart of the American ethic whereby private enterprise and Government would work together to complement the common goals.

In conclusion, I would refer to provisions in H.R. 1635 which move counter to the efforts that we in the development field feel to be positive. The adjustment proposed in the schedule of depreciation for projects using industrial development bonds under H.R. 1635 is a complete reversal in philosophy which we saw from this body in 1981. There is no double dipping, in our opinion, when we are discussing jobs, profits, and new Federal tax revenues through the use of industrial development bonds.

Also, H.R. 1635 would restrict the use of industrial development bonds by denying the use of tax-exempt bonds to large businesses, defined in the bill to include any entity whose capital expenditures exceed $20 million during the 3 years prior to the bond issuance.

To underscore the severity of this restriction, I called the Texas Industrial Commission to see the effects that this provision might have on a single large State other than my own state of Mississippi. During 1982 Texas authorized industrial revenue bonds for 492 projects of which 292 were strictly manufacturing operations, and of those projects more than half were considered large projects. The investment inducement offered by industrial development bonds assisted in the creation of 22,588 new jobs in the State of Texas alone during 1982, according to the Texas Industrial Commission.

During an era in American history when every national poll that we have access to indicates that jobs are the closest thought to the American conscience, we cannot conceive of our elected officials abandoning a Federal program which has left a trail of success stories from areas in poverty-stricken northwest Mississippi through the rapidly growing State of Texas and on to almost every State in our country.

We strongly urge you as a body to allow the current programs which were outlined under TEFRA last year to be fully implemented before any further changes are in force regarding industrial development bonds.

Thank you, Mr. Chairman.

Mr. SHANNON. Thank you, Mr. Morgan.

Mr. Potts.

STATEMENT OF RAMSAY D. POTTS, COUNSEL, NATIONAL COMMITTEE ON SMALL ISSUE INDUSTRIAL DEVELOPMENT BONDS

Mr. POTTS. Mr. Chairman and members of the committee, my name is Ramsay Potts, and I am counsel to the National Committee on Small Issue Industrial Development Bonds. Our committee has 74 members, principally corporations, that use IDB financing.

I would like to make four points, Mr. Chairman, if I may. The first point is that the Treasury figures on revenue loss do not stand up under analysis. Treasury figures revenue loss on the basis and on the assumption that every individual investor or institution which currently holds a tax-exempt IDB would transfer that investment to a taxable bond if IDB's were not available.

Every independent study has shown that investors who own a tax-exempt investment shift to another tax exempt or to a tax-sheltered investment if the first tax-exempt investment ceases to be available. They do not go in the market and buy a taxable bond. So there is a great fallacy in the Treasury figures.

The second point I would like to make is that 48 States are successfully using IDB financing, creating jobs, encouraging new high tech and growth industries. In my testimony I give examples of such successful use by Massachusetts, Minnesota, New York, Texas, Michigan, Rhode Island, Connecticut, Louisiana, New

Jersey, and Mississippi. And we have examples from every State if we wanted to use them.

The third point is a point that I think is absolutely vital, Mr. Chairman, and I hope the committee will pay serious and careful attention to it. The point was made by Lieutenant Governor Kerry, and I think it is vital.

The cost of capital is a prime element in the ability of U.S. companies to compete in foreign markets. I have just a few figures I would like to call your attention to. I know you are probably familiar with them, but it certainly is worth repeating.

Japan uses preferential interest rate financing. In fact, they use interest-free loans to encourage export-related priority industries. And they also have in conjunction with that program a rapid depreciation schedule. Loans made for technology projects by MITI—Ministry of International Trade and Industry—bear no interest. Loans made by the Japanese Development Bank bear a preferential interest rate.

And if you analyze the situation and realize what has happened to us, you will see that the cost of capital is even more important in terms of the noncompetitive position of our industry than is the cost of labor.

Finally, I would like to make a conclusionary point. We oppose H.R. 1635, Congressman Pickle's bill, because TEFRA, enacted last year, has just gone into effect. It made significant reforms, and we think you ought to give these provisions time to take effect. We hate to see your committee and the Congress every year tinkering, changing the ground rules and upsetting the 48 States and municipalities who are trying to make this program work.

Thank you very much, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF RAMSAY D. POTTS, COUNSEL TO THE NATIONAL COMMITTEE ON SMALL ISSUE INDUSTRIAL DEVELOPMENT BONDS

Mr. Chairman and members of the Committee, my name is Ramsay D. Potts. I am counsel to the National Committee on Small Issue Industrial Development Bonds. I am also a senior partner in the Washington law firm of Shaw, Pittman, Potts & Trowbridge. I appreciate this opportunity to present the views of the National Committee on small issue industrial development bonds (small issue IDB's). The National Committee on Small Issue Industrial Development Bonds is a non-profit membership organization dedicated to preserving and increasing the effectiveness of small issue industrial development bonds as mechanisms for capital formation and job creation. The Committee currently has 74 members, principally user corporations, but also state economic development organizations, investment bankers and other supporting individuals and groups. A list of members of the National Committee on Small Issue Industrial Development Bonds is attached (Attachment A).

Our Committee has been actively involved in matters affecting small issue IDB's since 1978. Our members have worked closely with state and local economic development authorities to understand their needs and concerns. Several state authorities are supporting members of our Committee. The National Committee has commissioned two studies on small issue IDB's. The first, "The Economic and Federal Revenue Effects of Changes in the Small Issue Industrial Development Bond Provisions" by Dr. Norman B. Ture, former Undersecretary of the Treasury for Tax and Economic Affairs, was published in 1980. The second on "The Federal Revenue Losses from Industrial Development Bonds" by Roger C. Kormendi and Thomas T. Nagle of the University of Chicago, was published in 1981. The studies were submitted to this Committee at the Hearings on "Small Issue" Industrial Development Bonds before the Subcommittee on Oversight, April 8-10, 1981. Copies of these studies are available from the National Committee.

SPECULATIVE REVENUE LOSS

The National Committee recognizes that there are different views regarding the impact on the Federal revenue of small issue IDB's, depending on the formula or approach used. The dynamic or feed-back approach, advocated by Dr. Ture in the study he did for the National Committee, concludes that the Federal Treasury gains net revenues from the IDB program. Doctors Kormendi and Nagle show foregone federal tax revenues in the order of $4 to $6 million dollars for each billion dollars of new IDB's when interest rates are in the range of 10 percent to 14 percent. These estimates contrast sharply with the Treasury's and CBO's estimates of $30 to $40 million for each billion dollars of bonds. In any event, the dollar figures of revenue loss from small issue IDB's advanced by critics of the program are entirely speculative and small in comparison with the revenue losses from other more recently-enacted tax provisions, and the cuts in personal income tax rate.

Treasury's figures on revenue loss are based on the assumption that every individual investor or institution which currently holds a tax-exempt IDB would transfer that investment to a taxable bond if IDB's were not available. That assumption is patently ridiculous. Every independent study has shown that investors who hold a tax-exempt investment shift to another tax-exempt or tax-sheltered investment if the first tax-exempt investment ceases to be available. There is a range of tax-exempt or tax-sheltered investments available to investors and they continue to purchase such investments in order to reduce their taxable income.

IDB's have been blamed for forcing up the interest rates of all other tax-exempt issues. Pressure on the municipal bond market, however, is coming from many sources, most of which have a far greater impact on the interest rates of general obligation and revenue bonds than the presence of small issue industrial bonds. For example, U.S. Government borrowings in the range of $85 billion in net new funds in 1982 overshadows the impact of all other parties seeking credit.

The weakening of credit of municipal issuers has also affected the interest rates at which new issues are offered. In the last few years, the downgrading of municipal issuers has doubled and the upgradings have declined to less than half of their 1973–1978 average. Municipalities are facing increased budgetary needs and reduced Federal grants which put additional pressure on their credit ratings and put upward pressure on their interest rates.

Furthermore, the benefits of IDB's are usually ignored by those critics who reduce the debate to a question of revenue loss.

BENEFITS OF IDB'S

Small issue IDB's are now being used to finance facilities in 48 states from Alaska to Florida from Maine to California. IDB's provide access to capital, which makes possible the much-needed investment in plant and equipment and creates new jobs or retains existing jobs. With unemployment still at 10 percent, communities need IDB's to create or retain jobs. Furthermore, the location or retention of an IDB-financed major facility in a community frequently serves as an anchor and creates a ripple effect, attracting other smaller firms, creating service jobs, increasing the local tax revenues and encouraging further economic development.

Unemployment continues to be severe in certain industries and geographic areas which have used IDB's successfully for the creation and retention of jobs. The effectiveness of IDB financing in creating jobs has been demonstrated by the following information provided to us by the States. For example, Michigan Job Development Authority shows 3,793 jobs created or retained with the issuance of $59 million of bonds in the period from 1979 to 1981. The Connecticut Development Authority reports that between 1973 and 1982, it approved more than $1.3 billion in capital financing for about 1,000 companies, which has helped to secure approximately 70,000 existing jobs and has assisted in the creation of another 44,000 new jobs. The New York State Industrial Development Agency reports 103,707 new or saved jobs through the issuance of $1.9 billion of bonds for 966 projects in the period from 1970 to 1981.

Louisiana estimates that it has created or anticipates the creation of 9,667 permanent jobs and 15,999 temporary jobs in connection with IDB projects financed with IDB's from 1979 to 1981. In four years, Massachusetts has created 58,000 new permanent jobs through the use of IDB financing. Texas in 1981 approved 242 IDB issues which are estimated to create 18,172 jobs. Minnesota reports that 23,000 jobs were or will be created by IDB's approved in 1981. Rhode Island estimates that IDB facilities created 1,781 jobs in 1981. New Jersey reports that 65,000 persons are currently employed in premanent jobs that have been created by IDB financed facilities since 1974. For 1981, New Jersey estimates that 13,336 new permanent jobs and

11,182 construction jobs were created from the IDB financed facilities. St. Louis County Industrial Development Authority has issued 98 bonds since its inception in 1979 for facilities which have created or will create 4,800 jobs in St. Louis County. The New York Times devoted half a page on June 6 to the success story of Springfield, Massachusetts, a city that has received $38 million in IDB financing and has been a model for urban renewal. As a result, unemployment has been held below 7 percent.

Mississippi, the first state to use an IDB program, has continued to use it almost entirely for industrial purposes. Like the other states, Mississippi has no prohibitions regarding the size of a company that may use IDB financing. Over a 40-year span, Mississippi has used IDB financing to build plants for at least 55 corporations among the Fortune 500 industrial corporations and credits its IDB program as vital in its development of industrial facilities and industrial jobs in the State.

OPPOSITION TO CONGRESSMAN PICKLE'S BILL H.R. 1635

The National Committee strongly opposes Congressman Pickle's bill H.R. 1635. The National Committee believes there are compelling reasons why such legislation should be rejected.

The National Committee recongizes that there has been publicity about and criticism of aspects of the small issues IDB's. The Committee believes, however, that the IDB reforms enacted in the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") eliminated the abuses and reformed the programs. Controversial uses of small issue IDB's have been prohibited. New requirements of recordkeeping and public approval have been imposed. Additional limitations on IDB's are unwarranted at this time when bond issuers and users have not had sufficient time to evaluate the changes enacted less then one year ago in TEFRA. The communities continue to need flexible economic development tools to deal with high unemployment and high interest rates.

The H.R. 1635 provisions that would require lengthy recovery periods for assets financed by IDB's were rejected by the Congress last year and are counterproductive to the Administration's goal of economic recovery. Assets financed by IDB's already have to be depreciated using the straight-line method, rather than the 150 percent rate available to assets financed by other methods. To extend the recovery periods would hurt the firms and industries that are in greatest need of IDB financing: growth companies, new companies, companies that are not currently showing high rates of return, because for these firms and others the initial cost of the capital is the critical factor. IDB financing reduces the initial cost of the financing and spurs the modernization of plant and equipment now rather than at some future date. Businessmen continue to be concerned about the persistent high interest rates which contributed to the poor economic climate of the last two years, prevented investment, created unemployment and reduced output. They have delayed investment decisions because of interest costs, which once incurred, unlike some operating costs, do not decrease during periods of economic slowdown. Until interest rates are substantially reduced, IDB financing is one of the few ways business can undertake new investments in plant and equipment.

H.R. 1635's limitations on the use of small issue IDB's by medium and large-sized businesses are also counterproductive to the nation's economic recovery because:

(1) No state at present excludes medium or large-sized businesses from its IDB program. Indeed, the states and local governments want to retain the right to decide when and where they want medium or large-sized businesses to locate in their communities since it is these firms that serve as a magnet for attracting other firms, generate increased tax revenues and generally are responsible members of the community. Moreover, the arrival or retention of a medium or large-sized firm is a catalyst for economic recovery because it creates a ripple effect of additional jobs, services and investment in the community. The state and local governments are facing substantial cuts in federal assistance, decreased tax revenues, and increased transfer payments. They need IDB's now more than ever to provide economic development and to replace the programs and services that have been terminated by the Administration's budget cuts.

(2) Medium or large-sized businesses face the same problem of the cost of capital that all businesses face, and have postponed investment and reduced employment as they are squeezed by the unfavorable economic climate. When considering the construction or expansion of a facility, large companies, just like small ones, must evaluate the costs and potential returns before an investment can be made. In order to be approved, the project must pass the "hurdle rate" for return on investment. At today's interest rates projects of even the largest companies often do not exceed

the hurdle rate if they must be financed by market rates. Eliminating the use of IDB's by medium or large-sized companies will reduce capital investments as projects are delayed or abandoned.

(3) Elimination of medium or large-sized businesses from the IDB program would discriminate against manufacturing and industrial firms. These are the firms that have major capital expenditures and that have been most affected by the recent interest rate-caused recession.

(4) H.R. 1635 defines large business as one that has capital expenditures in excess of $20 million during the three years preceding the issuance of the IDB. This cap on worldwide capital expenditures would affect many small firms, particularly high technology firms. These firms operate in a highly competitive, rapidly evolving industry in which equipment and products must be updated constantly. Although many of these firms are small, they frequently have worldwide capital expenditures in excess of $20 million in a three-year period, and they have the potential to grow rapidly. H.R. 1635 would discriminate against the most productive uses of IDB's for high technology and manufacturing exports in which the United States remains, for the time being, the world leader. The United States position, however, is being eroded in these fields as it has been in such industries as automobiles, steel, cameras, televisions and radios. The present $10 million limit on the bonds issued and on the capital expenditures within a six-year period already imposes severe restrictions on the size of facilities financed with IDB's. If the 1968 limits had kept pace with inflation, the $5 million limit enacted in 1968 and the $10 million enacted in 1978 would be $15 million today.

(5) The H.R. 1635 provisions that limit corporations to $20 million in outstanding small issue IDB's at any time would also eliminate corporations of all sizes, if a firm had financed several facilities with small issue IDB's. It would also remove from the states and local governments the authority to choose what investment or economic development mix they want.

FOREIGN TRADE AND COMPETITION

Favorable interest rates for borrowing to finance new plant and equipment are essential if United States firms are to compete in the domestic and international markets.

(1) Japanese use preferential interest-rate financing. In fact, they use interest-free loans to encourage certain export-related priority industries, in conjunction with a rapid depreciation schedule to encourage investment. Loans made for technology projects by the Ministry of International Trade and Industry ("MITI") bear no interest. Loans made by the Japanese Development Bank ("JDB") bear a preferential interest rate. Furthermore, the discount rate of the Central Bank of Japan is only 5.5 percent. Savings are encouraged by making the annual interest on the first $3 million yen deposited in the Postal Savings System tax-free for each depositor. In addition, the annual tax-exempt interest rate on these savings is 6.25 percent, which is the same rate as the taxable interest earned on time deposits at commerical banks.

(2) Because of these favorable Japanese interest rates, American firms which have to borrow money at higher rates have great difficulty in producing a competitively-priced product. As a result American firms are increasingly losing out in both the international and the domestic markets to Japanese firms and to other foreign firms which can obtain capital at a lower cost.

CONCLUSION

H.R. 1635, by preventing medium and large-sized businesses and growth industries from using small issue IDB financing and by extending the depreciation recovery period for assets financed by IDB's, will have a damaging economic impact on the communities that seek to attract industry, on the jobs created or retained by IDB financing, and on the competitive position of United States firms against Japanese and other foreign firms. Moveover, the damaging economic impact will far outweigh any estimated revenue gains from elimination of the use of IDB's by medium and large-sized businesses.

The economy is going through a period of uncertain recovery in which high interest rates are still a concern. Competition from foreign manufacturers is eroding the position of United States industry in both international and domestic markets in an ever-increasing number of product lines. In addition, with the Administration cutting back on many programs and services provided to states, cities and local communities, IDB programs remain one of the few financing tools available for states, cities and communities. The National Committee is convinced that this is the wrong time to be imposing additional restrictions on small issue IDB's, when the TEFRA reforms have been so recently put into effect and cannot be adequately evaluated until more time has passed. Moreover, the National Committee is convinced that concern over small issue IDB's has been blown out of all proportion to the estimated revenue loss from small issue IDB's. The IDB programs are productive, popular and economically beneficial programs.

Additional restrictions are unwarranted at this time.

NATIONAL COMMITTEE ON SMALL ISSUE INDUSTRIAL DEVELOPMENT BONDS, May 1983

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Middle Tennessee Industrial Development Association.
Commonwealth of Virginia, Division of Industrial Development.
Watkins, Ludlam & Stennis.
Wright, Lindsey & Jennings.

Mr. SHANNON. Thank you, Mr. Potts.

Mr. Potts, let me, if I could just comment on your last remark, we are tired of tinkering, too, because this tinkering that we are forced into, have been forced into each of the last couple of years, not only creates uncertainty among State and local governments but also among investors, and I think if there is one thing we want to restore, it is some certainty to the whole economic climate. And I would be less than honest with you if I told you or indicated that there was any chance of creating that certainty with the sort of budget deficits that we have presently.

And until we can get our fiscal policy under control, I think it is going to be very, very difficult for us to stay away from these types of provisions and look to tightening them up. And so we certainly welcome your testimony, and your input, and your experience in trying to do what we can to make sure we have a fair tax policy and one that is involved in the kind of activity that tax policy should be involved in without giving excessive subsidies or creating excessive loopholes that people can take advantage of.

Lieutenant Governor Kerry, I want to thank you for your testimony. I know that the Massachusetts agency has been considered one of the better, if not the best, of all of the State agencies. I know you recognize, as does Governor Dukakis, that it is not a perfect agency and that there are probably ways in which we can work together to try to improve those laws, both at the State level and here in Washington.

I want to thank you for your testimony and for you advice on this and other issues. Your attitude and the attitude of your administration has been very open and helpful, and you are, I know, just as interested as all of us are in making sure that these Federal tax policies do what they are supposed to do.

Mr. KERRY. Thank you, Congressman. I appreciate your courtesy.

Mr. SHANNON. Mr. Pickle, would you like to inquire?

Mr. PICKLE. I thank you. I regret that I had to go to a luncheon with some constituents, and I missed part of this testimony. I am advised, though, that one of your witnesses, Mr. Morgan, decided that he ought to compare projects in Texas with Mississippi or some other State.

I want to ask you, first, do we have a copy of all the industrial development bonds that have taken place in Mississippi in the last 2 or 3 years? If not, I want you to submit them to our committee, every one of them.

Mr. **Morgan**. Yes, sir.

Mr. **Pickle**. I also will get the list from my State. I will say to you that the State of Texas in the last couple of years, has been using industrial development bonds just like Mississippi, I do not know whether in any greater number or not; but I know in the last couple of years, they have had over 500 projects approved through the State offices and that the volume is in excess of over $1.5 billion.

Now, why would a local community not want to use industrial development bonds when it has no responsibility and it does not cost you anything? My State likes that. They are going to use it until we put some kind of restraint on it.

So I say to you, there are abuses in places. One of your delegation from Mississippi said to me he thought we ought to continue these things. He said, well, we are building a lot of facilities down there. And come to find out what he really had in mind was that Du Pont had built one project in particular worth over $40 million, built it through industrial development bonds.

Do you approve of that?

Mr. **Morgan**. You are asking me?

Mr. **Pickle**. Yes. Do you approve of that?

Mr. **Morgan**. Yes, sir. Most definitely.

Mr. **Pickle**. Then the Federal Government is taking up then a loss of revenue of around $8 to $10 million of that amount of money or more. About 25 percent of $40 million, upward of $8 to $10 million. That is loss of revenue to the Federal Government.

Now, why should the Federal Government finance Du Pont's project of $40 million down in Mississippi?

Mr. **Morgan**. Would you like for me to respond to that?

Mr. **Pickle**. You bet.

Mr. **Morgan**. Mr. Pickle, based on data we have from the Mississippi Research and Development Center, and this is also based on the way Mississippi runs their program, we do not allow uses of industrial revenue bonds for anything except manufacturing and manufacturing-related uses—most unlike your State of Texas.

In your State of Texas, last year there were 492 projects approved. Of that amount, 202 were projects other than manufacturing uses. So we have a little bit different criteria for the issuance of industrial revenue bonds.

Back to my point on the statistics that we brought to this committee last year regarding industrial revenue bonds in Mississippi, we have statistical data that show that payroll taxes alone paid back to the Federal Treasury through jobs created in manufacturing facilities in the State of Mississippi for that same year paid more than what the Federal Treasury lost through the tax exemption on industrial revenue bonds.

Mr. **Pickle**. Why does not Du Pont, one of the richest corporations in the world, finance it if they want to build a project in Mississippi through normal conventional financing methods? Why do they ask the Federal Government to pay their bill for them?

Mr. **Morgan**. Mr. Pickle, I referred in my testimony that we felt that this financial inducement offered an incentive that sometimes would not—there would not be an investment without.

Mr. **Pickle**. The local entity does not have any responsibility for it. They use the financing of a third party. They do not have any responsibility. And if they finance it, usually they issue IDB's or enter into a sales lease project. They give a tax exemption to a third party. They do not have to go to the voters. They do not get the voters approval. They have no risk. It is all free Federal money.

Now, I would say, if I was on the city council, that is a pretty good deal, and I would go after it just like you folks are. But in this instance, I represent not only my city but I also represent the Federal Government. With a $200 billion deficit, how can we afford to keep on losing, as we showed this morning, upward of $15 billion a year for the next few years if we continue this program? Where do we get the money?

Mr. **Morgan**. Mr. Pickle, we, too, extend a lot of incentives locally to industry that locates through industrial revenue financing which costs our communities dearly out-of-pocket expenses through tax incentives and tax inducements that are local and have no bearing on the Federal Treasury.

This is something that we automatically extend to industry that comes into the area in order to get them to locate in our area as opposed to possibly other areas in Arkansas or Louisiana.

Mr. **Pickle**. And you do so by asking the Federal Government to finance those projects.

Mr. **Morgan**. No, sir. We do it through property tax exemptions, franchise tax——

Mr. **Pickle**. No; I am talking about the bond issues, floating the bonds and that type of thing, the revenue that we lose. I asked you why do you not do this through normal conventional financing means? Why does not Du Pont do that?

Mr. **Morgan**. Mr. Pickle, unlike your State of Texas, Mississippi is a capital deficit State.

Mr. **Pickle**. Now, that is what I object to. You try to single out my State. I am not trying to protect my State. My State is not any different from yours. The local communities, a lot of them need it just as much as Mississippi, so do not say because we are a richer State than Mississippi per capita. I imagine our figures are about the same. Let us not get into that. I am not going to allow you to pit Mississippi against Texas because that is not the issue. The issue is a Federal issue. It is a national issue. And as long as our cities and our counties want to let Uncle Sam finance these projects, then our deficit is going to get bigger and bigger and bigger, and you are part of the cause of it, and I am if we permit it to continue.

I just say to you that at some point our cities and counties have to make that analysis of what is in the national interest, should we continue these things or not. If we had plenty of money in the Federal Government, well, then perhaps we could look the other way and say Mississippi needs to be developed or Texas needs to be developed in areas, and we will just go ahead and hunker up and accept this deficit.

But we do not have that kind of money, and in an effort to try to help your cities or communities we are going broke fast. Now, we just cannot permit that. And I just ask the States and the cities and counties not to be provincial about this—and I am talking about a particular project—but thinking in terms of the national issues. That is what I ask you to do.

Mr. **Morgan**. Mr. Chairman, may I respond to Mr. Pickle's comment?

Mr. Pickle, I will have to step back from where I am presenting for 17 States and say that I certainly was not reflecting on trying to pit Texas against Mississippi.

Mr. **Pickle**. Oh, I think you were trying to do exactly that, thinking that that would make your State more deserving as compared to our State, but you could compare it to New York, or you could compare it to California or the rich State of Massachusetts. We ought not make these kinds of comparisons.

Mr. **Morgan**. Well, I made that comparison because Texas is a rapidly developing State, and the area of Mississippi which I represent is not a rapidly developing area. I made in my comment the statement that in our area over half the people in our area of a half million people and a geographical area the size of Maine derives half of their personal income from transfer payments. So I believe we are a little less rapidly developing than most areas of the country. I only took Texas because I have a friend in Texas who gave me this information from the Texas Industrial Commission.

But stepping back from who I am representing today at these hearings, I will say this. In the State of Mississippi, and representative of what our congressional delegation from Mississippi endorses, we would restrict industrial revenue bonds just as they have been restricted in Mississippi; and when you restrict them to that degree, we believe that they are not a deficit on——

Mr. **Pickle**. Maybe, Mr. Morgan, we are more in agreement than we think. I am not trying to kill the industrial development bond program. The bill we have introduced actually would only make a savings of approximately 6 percent of the amount of loss of revenue, only 6 percent out of the total amount that was involved. It is really just a small beginning. It goes a little further than we did in the TEFRA bill. But we have got to make some changes. Perhaps we are closer together than we think. I would hope so, and I welcome the chance to visit with you further.

Mr. **Morgan**. Yes, sir. Thank you.

Mr. **Shannon**. Mr. Downey, do you have any questions?

Mr. **Downey**. Thank you, Mr. Chairman.

It is always engaging to hear our colleague from Texas. The next time you come, Mr. Morgan, you will not use Texas as a State to compare anything with, I hope.

I would like to know just offhand how—let me start with you, Mr. Morgan, and some of the other panelists—how you would restrict the use of industrial revenue bonds, because while I am inclined to be a bit more sympathetic to the use of industrial revenue bonds than is my colleague from Texas, I do agree that a lot of the private purposes, and especially the small issue industrial development bonds, have been abused. So I would like to hear what recommendations, if any, you have to this committee on how you would temper their use.

Mr. **Morgan**. Mr. Downey, I have for the last 3 years surveyed a number of States' ways of restricting such as the State of Massachusetts and others who have done quite an effective job of targeting industrial revenue bond use to distressed areas.

However, it is our contention in Mississippi at least for what our program has benefited us that the most effective way to limit the use of industrial revenue bonds is through limiting by purpose of the user and not by the size of the company utilizing industrial revenue bonds.

We have garment plants, cut and sew plants for people who cannot find other manufacturing jobs because they do not have the skills to do other manufacturing jobs. We have garment plants that actually expend more than $20 million over a 3-year period in developments which are obviously not large companies or large businesses.

We feel that if the committee would consider the possibility of limiting the use of industrial revenue bonds by their purpose through surveying the standard industrial classification for all businesses in the United States and then zero in on a certain classification of the Standard Industrial Classification Code which is accepted throughout this Nation and internationally, that this would be the way that we would propose for industrial revenue bonds to be limited.

Mr. **Downey**. Thank you.

Let me ask the Lieutenant Governor if he has any recommendations.

Mr. **Kerry**. Well, Congressman, thank you.

In Massachusetts we have undertaken a certain amount of targeting effort, and we are tying the issuance of our commercial bonds to commercial area redevelopment to the CARD district concept.

Congressman Shannon and I were discussing this earlier today, and he made the point, and I think makes it well, that to some degree the process by which we have delineated what is a commercial area redevelopment district may be subject to some need or some tightening so that you do not again open up a whole loophole concept.

But I think the key is to begin to focus on the size of business, perhaps the sales, total sales that a business does; and I know you are doing that in this bill with the $20 million sales. I think Massachusetts feels that that might be too delimiting. We would probably prefer something in the area of $50 million, because you can look at some of our most long-term negatively impacted areas such as Lynn, Mass., and Lowell and others which were the old textile areas where our historic buildings are and also where we have suffered dislocated workers. And most of the businesses in those areas, about 25 percent of them are under $50 million in size.

I take it Massachusetts would join in saying that it is wrong for some of the larger companies with major capital formation opportunities and other things to be able to take advantage of it; but I think the key is in the targeting.

There are hosts of ways, obviously, in which that can be approached, and I think you are tracking some of them. But I think I would separate commercial from industrial. I think industrial should be much freer, because I think the spinoff from industrial is that much greater.

Mr. Downey. Let me ask you, the point is made by the chairman and others that this use of tax-exempt finance as it grows and has continued to grow inevitably adversely affects the interest rates that would be available for other public purposes—roads, bridges, that sort of public issue.

How, as a policymaker for the State, do you handle that concern of this committee that, you know, tax-exempt finance was designed initially to do public purpose and now appears to be doing a mixture of public and private, but that there is a cost to bear for increasing your State income tax or property tax because the rate you give is not as high as it once was or as favorable as it once was because of these other tradeoffs.

Mr. Kerry. Well, I think there is a cost to bear, and I think that is really the bottom line. You have to just accept that. There is a cost to bear, but at the same time you have got to balance that against the benefits.

It is my view, and I think Governor Dukakis' view and our development office's view in Massachusetts that when you measure the benefits—and we have had 235 high tech companies grow in the last 3 years with 18,000 new jobs—now, those 18,000 new jobs are part of what has kept us at a 7 percent unemployment rate which has lessened the pressure on workman's comp, on unemployment benefits, on a host of other areas where we are called on to pay money, and in addition has provided a tax base, and from that tax base comes a greater capacity to address the problems of roads, sewers, pipes, et cetera.

Second, and we are currently looking at this very carefully, we are putting together a major infrastructure package in Massachusetts, hopefully where we can fund a great deal of it ourselves. And we are looking at how we can also involve the Federal Government in that.

I think the bottom line, Congressman, is it is a tradeoff, and the question is is the benefit outweighing that cost. And we believe very firmly, particularly—and you were not here when I made the comment—I see the red light is on, but if I could just finish the thought—particularly when you consider how the entire economic structure of the world is changing. You know, there can be 36 million people added to the work force each year in the next 20 years, and 85 percent of them are going to be in other countries. Seventy percent of our goods are competing in those other countries. We are losing businesses to every other country in the world simply because people can do business for less there.

The Japanese for years, and everybody has been heralding it here for years, have approached financing and capital formation in a different manner than us, and the result is that we are falling further and further behind, and I think in the long run we are going to be under greater and greater pressure in our standard of living unless we respond with these kinds of measures. I think they are critical.

Mr. **Downey**. Thank you, Mr. Chairman.

Mr. **Shannon**. Mr. Duncan.

Mr. **Duncan**. Thank you, Mr. Chairman.

I apologize for not being here for the entire discussion, but my hometown just announced last Saturday that they were going to sell the sewers. As one of the newspaper headlines said, they were in a hole, and they were going to sell the sewers.

One of the stock exchange firms was going to give them $70 million, and they were going to pay off the sewer bonds for $50-some million and give the police, firemen, and schoolteachers all a raise with what they had left.

What are your thoughts on something like that?

Mr. **Kerry**. Are you asking me? Congressman, I am afraid I am not familiar enough with the specifics of that proposal.

Mr. **Duncan**. Well, there are similar proposals going around. They are selling——

Mr. **Kerry**. Like the transfer to private sector?

Mr. **Duncan**. I have always been a supporter of industrial revenue bonds, but I think that you are going to kill the goose that lays the golden egg if we are not careful. In fact, we had here in Virginia a massage parlor built a few years ago under the guise, I think, of an office building.

Mr. Morgan or anyone who would like to respond, what about municipalities or local governments selling their facilities?

Mr. **Kerry**. I think, Congressman, it is my impression that there are certain areas of the Government that lend themselves appropriately to consideration for transfer to the private sector. We have been doing that successfully with some water commission at least to a quasi-private to the public authority concept. And I did take note in the sale in Oakland of I believe it was the museum out there which is being run by the private sector now.

I think there are things that we can examine for that. I do not adopt it wholesale, certainly not with respect to some of those things you mentioned. But I do believe there are definitely areas of the government which would lend themselves to that examination and to that transfer.

Mr. **Duncan**. And it is subject of abuse? Would you agree?

Mr. **Kerry**. Yes, sir.

Mr. **Duncan**. With respect to the actual issuance of what we call real industrial revenue bonds, if we go too far in selling——

Mr. **Kerry**. It is subject to it, yes, sir. I do think there are ways in which that can be limited.

Mr. **Duncan**. Mr. Morgan, do you care to comment on that?

Mr. **Morgan**. Mr. Duncan, I had already made a comment in response to Mr. Pickle's question that my own recommendation, representing no one except my own organization, which has gone on record proposing that these bonds be limited by purpose by the Congress of the United States. And it would be to the wisdom of this group to decide what purpose they would be utilized for, but certainly be restricted beyond the point that they would be damaging to the Federal Treasury, which we believe we have statistical data that shows that there is a point where that can happen. And we would ask for a close examination of the standard industrial classification, which is accepted by every business in this country and internationally, to determine which businesses would qualify and be eligible for tax-exempt industrial development bond financing.

Mr. PICKLE. Would the gentleman yield?

Mr. DUNCAN. I would be glad to yield.

Mr. PICKLE. How would you feel, Mr. Morgan, about requiring a local entity to make a contribution to the project; that is, 1 to 10 percent. Let them put up a piece of the action, put up some money. What do you recommend about that?

Mr. MORGAN. Mr. Pickle, I have not—we have not addressed that as an organization. But personally it would be my opinion that the tax exemptions offered to industry when they come in and the services that are provided to them free at no charge in our State of Mississippi would qualify for that type of investment because we are foregoing property taxes which would accrue tremendous benefits to our State if——

Mr. PICKLE. You would not recommend that the local county or the city put up 1, 5, or 10 percent of the funds?

Mr. CONABLE. Put it up in tax forgiveness.

Mr. MORGAN. I have not given it enough thought as to the different angles we can approach that from. I do not know if I could say blanket that we would just do it on a percentage basis.

Mr. PICKLE. Mr. Morgan, the bill we have introduced would attempt to control the local issues by virtue of limiting the amount of funds that they could put into a particular project or have at any one time. We put limitations on it of $20 million on the side.

Would you think that is a preferable approach if we could put limitations on these things, or would you recommend a State cap, whatever cap we could agree on? Which would be preferable to you?

Mr. MORGAN. That is a difficult question, because I still maintain that it would be better to limit them by use or by purpose of the user, and this would limit the things that Mr. Duncan has referred to in his statement about the massage parlors and marginal uses of industrial revenue bonds, which have really been the glut on the market according to the CBO report.

So Mr. Pickle, I am sorry, I cannot give you a qualified answer on which one of those other two would be a better option.

Mr. CONABLE. There are disadvantages to each, obviously.

Mr. DUNCAN. Thank you, Mr. Chairman.

Mr. SHANNON. Mr. Conable.

Mr. CONABLE. I have no questions.

Mr. SHANNON. I want to thank the panelists for their testimony. The next panel is Mr. Owen, Mr. Mills, and Mr. Hawk.

Mr. DOWNEY [presiding]. Mr. Owen, why do we not begin with you and listen to Mr. Mills and Mr. Hawk in that order, and then the committee will be happy to ask questions and hopefully you will be equally as happy to respond to our questions.

STATEMENT OF JACK W. OWEN, EXECUTIVE VICE PRESIDENT, AMERICAN HOSPITAL ASSOCIATION

Mr. OWEN. Thank you.

I am Jack Owen, executive vice president of the American Hospital Association. I welcome this opportunity to present our views about tax-exempt bonds in the health care field. My written statement has been submitted for the record, so I would just like to make some comments with regard to that in the interest of time.

Over the past 30 years we have witnessed several basic shifts in the sources and use of hospital capital. Hospitals have become increasingly more reliant upon debt financing, particularly the tax-exempt bond market, shifting away from philanthropy and Government grants. In fact, most of those have dried right up.

In addition, the demand for capital continued to grow as facilities constructed early in the 1950's and 1960's become outmoded and need renovation and replacement. The Hill-Burton Act in 1948 and the early 1950's, provided substantial financing for capital projects, but we are now seeing the need for renovation of those hospitals.

In 1981, hospitals used about $5.4 billion in tax-exempt bonds. The "Bond Buyer" reports $9.7 billion in hospital tax-exempt bonds for 1982. According to our AHA figures, 10 States account for over 60 percent of all of these reported tax-exempt debts. They are, in order, Pennsylvania, Ohio, New Jersey, Florida, Texas, California, Illinois, Massachusetts, Kentucky, and New York. So you can see that it is across the board.

The vast majority of hospital capital projects are undertaken to replace or renovate facilities and equipment. These are legitimate and necessary projects that require capital, but add no new beds to the existing health care delivery system.

It is not true, as some contend, that the growing use of tax-exempt financing by hospitals has contributed to growth in construction. During the period 1975 through 1981, when the proportion of hospital construction financed with tax-exempt bonds rose from 31 to 54 percent, hospital construction spending was relatively stable, rising from $3.6 billion in 1975 to $4.3 billion in 1981. When inflation during that period is discounted, the real value of hospital construction actually dropped by $2.2 billion in 1981.

Nearly 75 percent of hospital projects undertaken were for modernization. Moreover, approximately 35 percent of all tax-exempt financing can be attributed to financing costs and restructuring of outstanding debt.

In addition, the recent enactment of prospective payment legislation, which changes medicare payments to hospitals from cost-based reimbursement to pricing based on diagnosis-related groups, will change hospital incentives. The shift in medicare to fixed prices will force hospitals to be even more cautious in capital spending because subsequent operating revenues are not guaranteed to support the capital assets.

Now, while hospitals continue to make record use of the tax-exempt market, there is no evidence they are abusing this source of capital. Four factors can be cited as largely influencing the recent heavy use of the tax-exempt market:

First, interest rates. The drop in interest rates in the second half of 1982 brought into the market many hospitals which had been delaying some needed projects.

The second was refinancing. Because of declining interest rates, some hospitals which had entered the market earlier chose to refinance their outstanding debt at more favorable rates. In 1982 refunding alone is estimated to have accounted for between 3 and 5 percent of total hospital tax-exempt issues. According to the Public Securities Association, refunding activities in 1983 represent almost 15 percent of overall market volume and 26 percent of hospital volume.

Third, the bond registration. The Tax Equity and Fiscal Responsibility Act of 1982 included a provision requiring the registration of all tax-exempt bonds issued after January 1, 1983. In an effort to avoid the extra cost, many issuers rushed to the market in late 1982, so we saw a little surge there.

And fourth, the large capital needs of the industry.

In conclusion, the importance of tax-exempt bonds to nonprofit hospitals are several: First, the medicare-medicaid impact. Since the Federal Government pays for about 40 percent of all hospital care, it obviously has an interest in the cost of capital used to finance that care. If hospitals are forced to enter the taxable bond market, then there is going to be additional cost.

Second, reduced cost. At a time when the Government, health care providers, consumers and Congress must cut hospital costs, tax-exempt financing is an important contributor to minimizing the cost.

Third, the impact on financially weak hospitals. This is mostly important to those hospitals who are in rural areas or in inner cities, where they do not have the number of paying patients who will allow them to go to the taxable bond market, and these types of hospitals need tax-exempt financing.

And fourth and lastly, we strongly believe that private nonprofit hospitals serve an unquestionable public purpose in providing high quality health care services to the community. The vast majority of hospitals in this country provide these highly complex services at no charge to the poor, the medically indigent, and need this tax-exempt capital financing to stay in business.

This concludes my oral statement, Mr. Chairman. And again, I appreciate having the opportunity of appearing before the committee and I would be happy to answer any questions.

[The prepared statement follows:]

STATEMENT OF THE AMERICAN HOSPITAL ASSOCIATION, PRESENTED BY JACK W. OWEN

Mr. Chairman, I am Jack W. Owen, Executive Vice President of the American Hospital Association (AHA) and Director of its Washington Office. The AHA, which represents over 6,300 member hospitals and health care institutions, as well as more than 35,000 personal members, is pleased to have this opportunity to present its views on trends in tax-exempt financing.

Tax-exempt financing is vitally important in minimizing the cost of must needed capital projects. For most nonprofit hospitals, it is the primary financing mechanism available for providing resources for capital projects that are absolutely essential in order to maintain our nation's hospital infrastructure in a rapidly changing technological and medical environment.

My statement will describe trends in tax-exempt hospital financing, explain the reasons for increased use of tax-exempt bonds, and describe the importance of this financing mechanism to nonprofit hospitals.

TRENDS

Over the past 30 years we have witnessed several basic shifts in the sources and uses of hospital capital. Hospitals have become increasingly more reliant upon debt financing, particularly the tax-exempt bond market, shifting away from philanthropy and governments grants. Changes in the economy and his health benefit coverage, as well as specific legislative and regulatory actions have also influenced the direction of capital financing. In addition, the demand for capital will continue to grow as facilities constructed early in the 1950s and 1960s become outmoded and need renovation and replacement. The health care industry will be continually challenged to develop new sources of capital funding if hospitals are to maintain the facilities and equipment necessary in delivering health care services.

Source of capital

Between 1975 and 1981 alone, reliance on government grants and appropriations as a source of funding of projects in community hospitals decreased from 11.2 percent to 3.5 percent, and philanthropy from 9.9 percent to 4.2 percent. Moreover, certain provisions of the Economic Recovery Tax Act of 1981 are expected to contribute to a further decline in philanthropic gifts as reductions in the personal tax bracket from 70 percent tc 50 percent reduce the incentive for philanthropic contributions. Over the same period, reliance on debt increased from 67.3 percent to 75.8 percent as an overall source of project funding. Seventy-eight percent of that debt was in the form of tax-exempt bonds in 1981.

Volume

In 1981, hospitals used $5.04 billion in tax-exempt bonds, representing 10.9 percent of the tax-exempt market. The Bond Buyer reports $9.7 billion in hospital tax-exempt bonds for 1982, or 12.3 percent of the tax-exempt market. According to AHA figures, 10 states account for over 60 percent of all reported tax-exempt debt. They are, in order: Pennsylvania, Ohio, New Jersey, Florida, Texas, California, Illinois, Massachusetts, Kentucky, and New York.

It should be noted that while the volume of tax-exempt bonds has increased from $262 million in 1971 to $2.7 billion in 1976, to over $5 billion in 1981, in constant (1967) dollars, the growth has been much more moderate—from $216 million in 1971, to $1.6 billion in 1976, to $1.8 billion in 1981.

Uses of capital

The vast majority of hospital capital projects are undertaken to replace or renovate facilities and equipment. These are legitimate and necessary projects that require capital but add no new beds to the existing health care delivery system. Over the past five years, community hospitals have increased their number of beds an average of only 1.1 percent each year.

It is not true, as some contend, that the growing use of tax-exempt financing by hospitals has contributed to growth in construction. During the period 1975 through 1981, when the proportion of hospital construction financed with tax-exempt bonds rose from 31 percent to 54 percent, hospital construction spending was relatively stable, rising from $3.06 billion in 1975 to $4.3 billion in 1981. When inflation during that period is discounted, the real value of hospital construction actually dropped to $2.2 billion in 1981.

According to AHA's Construction Survey for 1981, nearly 75 percent of hospital projects undertaken were for modernization. Moreover, approximately 35 percent of all tax-exempt financing can be attributed to financing costs and restructuring outstanding debt.

Checks on capital expenditures

Existing federal health planning authority and many state regulatory agencies continue to monitor the need for major capital expenditures by hospitals. Certificate of need (CON) review procedures are also required to verify the need for capital expenditures, major medical equipment purchases, and new institutional health services proposed by hospitals. CON approval of projects is also taken into consideration by bankers and state bonding authorities in making decisions to approve or deny tax-exempt financing for hospital projects.

In addition, the recent enactment of prospective payment legislation, which changes Medicare payments to hospitals from cost-based reimbursement to pricing based on diagnosis-related groups (DRGs), will change hospital incentives. The shift in Medicare to fixed prices will force hospitals to be even more cautious in capital spending, because subsequent operating revenues are not guaranteed to support the capital asset.

REASONS FOR INCREASED USE OF TAX-EXEMPT BONDS BY HOSPITALS

While hospitals continue to make record use of the tax-exempt market, there is no evidence that they are abusing this source of capital. Four factors can be cited as largely influencing the recent heavy use of the tax-exempt market: These include declining interest rates, the need for refinancings, increased cost resulting from bond registration, and large capital needs.

Interest rates

The drop in interest rates in the second half of 1982 brought into the market many hospitals which had been delaying needed projects. In January 1982, a typical hospital bond issue yielded approximately 15 percent, while in September 1982, yields were less than 10 percent. By year's end, hospital debt yielded about 11 percent, and last monthy (May 1983) hospital tax-exempt debt was yielding between 9.5 percent and 10 percent.

Refinancing

Because of declining interest rates, some hospitals which had entered the market earlier chose to refinance (re-fund) their outstanding debt at more favorable rates. In 1982, re-funding alone is estimated to have accounted for between 3 percent and 5 percent of total hospital tax-exempt issues. However, according to the Public Securities Association, re-funding activities in 1983 represent almost 15 percent of overall market volume and 26 percent of the hospital volume. Significantly, refinancing at lower rates reduces Medicare costs, because interest payments are reduced.

Bond registration

The Tax Equity and Fiscal Responsibility Act of 1982 included a provision requiring the registration of all tax-exempt bonds issued after January 1, 1983. In an effort to avoid the extra costs of issuing bonds in registered form, many issuers rushed to the market in late 1982. The deadline for registration was later postponed until July 1983, so, again this year, bond market activity is artificially heavy.

Large capital needs

Estimates of hospital industry capital needs for the 1980s generally exceed $150 billion. One firm estimates a $54 billion shortfall by the end of the decade. These substantial capital requirements and shortfalls suggest that capital may well be the most critical issue facing the hospital industry today.

These capital needs reflect the fact that much of the current hospital capacity was built during the 1950s and 1960s and is entering the stage at which major renovation and/or replacement is needed. Furthermore, the growth of the elderly population, with its high utilization rate, and demographic shifts to the sun belt have resulted in the need for new hospital construction in some areas of the country.

There have been many estimates by different sources of future capital requirements of hospitals. They include:

ICF, Inc.: $163 billion between 1981 and 1990; [1]

Kidder, Peabody & Co.: $193 billion between 1980 and 1990; [2]

Lightle and Plomann: between $100 and $145 billion over 20 to 25 years beginning in 1979; [3]

Reed and Winston: over $100 billion between 1981 and 1990; and [4]

Cohodes and Kinkard: between $80 and $100 billion in the 1980s.[5]

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[1] Valiante, J. The need for capital in health care: the national picture. Presentation, N.Y. State Assembly Forum on Capital Financing for Health Care, April 29, 1982. Also, the dimensions of capital requirements. Presentation, National Health Lawyer's Association, Jan. 20, 1982.

[2] Henkel, A. and Hernandez, M. Capital financing issues. Presentation, Society for Hospital Planning Seminar on Strategies for Hospital Diversification, Mar. 30–31, 1982.

[3] Lightle, M.A. and Plomann, M.P. Hospital capital financing entering phase four. Hospitals. 55:61, Aug. 1, 1981.

[4] Reed, T. and Winston, D. Difficult transition ahead: capital formation under the Reagan Administration. Hospital Financial Management. 11:6, June, 1981.

[5] Cohodes, D. and Kinkead, B. Hospital Capital Formation in the 1980's: Is There a Crisis? Study prepared at The Center for Hospital Finance and Management, The Johns Hopkins Medical Institutions; funded by The Robert Wood Johnson Foundation; Aug. 1, 1982.

IMPORTANCE OF TAX-EXEMPT BONDS TO NONPROFIT HOSPITALS

Tax policy

Taxable entities are entitled to investment tax credits and the deduction from income of accelerated depreciation and interest expenses. The tax exemption for interest on hospital bonds, guarantees, and direct loans makes the cost of borrowing for nonprofit hospitals comparable to the after-tax cost of borrowing for other enterprises. AHA considers it entirely appropriate that this type of assistance be provided to institutions.

Medicare/medicaid impact

Since the federal government pays for about 40 percent of all hospital care, it obviously has an interest in the cost of capital used to finance that care. If hospitals are forced to enter the taxable bond market to finance capital projects through commercial lending sources, the additional costs of hospital care will be significant and ultimately will be absorbed by Medicare, Medicaid, and other payers. During 1980, the savings to Medicare and Medicaid due to tax-exempt financing was estimated to be at least $150 million.

Reduced costs

At a time when health care providers, consumers, Congress, and the federal government are most sensitive to restraining the increase in health care costs, tax-exempt financing is an important contributor to minimizing the costs of capital projects. In the recent past, the interest rate for tax-exempt bonds was about 3 percentage points lower than comparable taxable obligations.

Impact on financially weak hospitals

While some nonprofit hospitals that are financially healthy may be able to use other debt financing options, financially weak hospitals will generally be unable to use those alternatives and might be denied access to capital if tax-exempt financing were not available. These hospitals are characterized as those providing substantial amounts of charity care or serving high proportions of Medicare and Medicaid beneficiaries. These types of hospitals are typically small and located in rural, isolated areas or are large hospitals located in inner cities. As a matter of public policy, Congress should not penalize those hospitals which are most committed to serving the aged and poor.

Public purpose

Most importantly, we strongly believe that private nonprofit hospitals serve an unquestionable public purpose in providing high quality health care services to communities. The vast majority of hospitals in this country provide essential and highly complex services, often at no charge to the poor and medically indigent. A study conducted jointly by AHA and the Urban Institute—a survey of 453 hospitals of which 86.7 percent were private nonprofit facilities—indicates that large public hospitals averaged about $32.8 million in free care to the poor, compared with $16.8 million for small public hospitals, $9.5 million for large private hospitals, and $3.4 million for small private hospitals.

In addition, hospitals also serve society through their education and research activities. Clearly, the continuing viability of our nation's nonprofit hospitals depends upon their success at capital formation.

CONCLUSION

In summary, the need for capital over the next decade is one of the most crucial issues facing the hospital industry. With the declining role of philanthropy and government grants in financing hospital capital needs, and the limited opportunities to generate capital through patient operations, tax-exempt financing has become the most cost-effective method of capital financing. Moreover, as institutions serving a public purpose that are vital to their communities, tax-exempt financing is an appropriate form of assistance.

Hospitals continue to make increased use of the tax-exempt market because of four factors: declining interest rates, refinancings, increased costs resulting from bond registration, and large capital needs.

If nonprofit hospitals are forced to turn to the taxable market, the overall cost of health care would rise. Moreover, the federal government would share in these increased costs through the Medicare and Medicaid programs, as would private payers and patients through increased premiums and charges.

H.R. 3110—GOVERNMENTAL TAX LEASING ACT OF 1983

While we recognize that these hearings are not designed to address H.R. 3110, the Governmental Tax Leasing Act of 1983, we would like to take this opportunity to briefly comment on this measure.

While we find that nonprofit hospitals are not extensively involved in lease-back arrangements that this legislation seeks to restrict, we are very concerned about provisions contained in this measure which would prevent equipment owned by leasing companies and leased by nonprofit hosptials to qualify for accelerated depreciation.

Generally, hospitals lease a great deal of sophisticated equipment that becomes obsolete very quickly due to changing technologies. The Lease Investment Corporation, as well as other witnesses, in testimony before this committee on June 8, 1983 outlined this situation and also indicated that if these provisions were enacted that lessors would incur large cost increases that would be passed on to nonprofit hospitals in their leasing costs.

At a time when the rate of increase in health care costs is already considered unacceptable, we view this situation with great concern.

Therefore, while we recognize that H.R. 3110 makes an important attempt to eliminate certain abuses which have taken place in lease-back arrangements involving governmental and other entities, we would strongly urge that this measure be re-examined to take the special and unique circumstances of nonprofit hospitals into consideration.

Mr. Downey. Thank you.

Mr. Mills.

STATEMENT OF FRANCIS F. MILLS, DIRECTOR OF FINANCING RESOURCES, BOSTON COLLEGE, ON BEHALF OF THE NATIONAL ASSOCIATION OF INDEPENDENT COLLEGES & UNIVERSITIES, AND THE AMERICAN COUNCIL ON EDUCATION

Mr. Mills. Thank you.

Mr. Chairman and members of the committee, I am Francis F. Mills, director of financing resources at Boston College. In addition to my specific college duties, I am a member of the Federal Relations Committee of the Association of Jesuit Colleges and Universities, and was recently elected to the presidency of the Massachusetts Association of Nonprofit Schools and Colleges.

I am pleased to be here to present testimony on behalf of the National Association of Independent Colleges and Universities, which is sometimes called NAICU, and the American Council on Education, ACE, representing over 1,500 public and independent colleges and universities, as well as the 10 other higher education associations listed on the front page of my testimony.

My president, Rev. J. Donald Monan, is currently chairman of the board of directors of the National Association of Independent Colleges.

I ask that a copy of the statement be made a part of the record of this hearing.

I would like to express the need for continued availability of tax-exempt bond financing for students at independent and public nonprofit colleges and universities in the United States, because we believe that such financing clearly meets the public purpose requirements and fulfills traditional government objectives.

In the press release which announced the tax-exempt bond hearings, we were pleased to note the fact that student loan and educational facilities bonds were not included in H.R. 1635, but were only mentioned in the background portion of the release.

The two pieces of legislation to be focused on today are industrial development bonds and mortgage revenue bonds. We are pleased, very pleased, that the legislation to date has recognized the distinction between our bonds and private activity bonds.

Tax-exempt bonds are today utilized for two major purposes in higher education: First, to obtain capital needed for constructing and renovating educational facilities, such as teaching hospitals, dormitories, student unions and the like, as well as major equipment purchases needed for modernization and research; and second, to raise capital for student loan programs, to assure that all eligible students will have access to higher education.

For example, within my own State there exists the Massachusetts Health and Educational Facilities Authority, which assists hospitals and colleges in the sale of tax-exempt bonds for the financing of facilities, and the Massachusetts College Student Loan Authority, which indirectly assists students by selling tax-exempt bonds to help them finance post-secondary education through the institutions they attend.

The Massachusetts Health and Educational Facilities Authority has issued tax-exempt bonds in an aggregate of $1.6 billion since the Authority was first created in 1968. Of that $1.6 billion, approximately $1 billion is for hospitals and about $600 million for colleges.

The Massachusetts College Student Loan Authority has made one issue of bonds. That was back in February of this year, aggregating a little more than $20 million.

Last year in the Tax Equity and Fiscal Responsibility Act of 1982, Congress recognized the public purposes that colleges and universities serve, requiring only reporting and registration in the case of student loan bonds or bonds for tax-exempt organization. We supported those provisions and suggest that no new conditions exist that would indicate a need for further changes in the law. We ask Congress to reassert that recognition and continue the treatment of colleges and universities as stated in TEFRA.

There has also been discussion of ways to limit the issuance of tax-exempt bonds for private activities. Although student loan and educational facilities bonds have been recognized as distinct from private activity bonds, we again would like to express our concerns.

I will be brief and wind down. Again, Mr. Chairman, we ask that current law as enacted by TEFRA be maintained, requiring both registration and reporting of bonds issued to finance student loans and educational facilities. And we further ask that we not be included in any type of volume cap proposals.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF FRANCIS F. MILLS, DIRECTOR OF FINANCING RESOURCES, BOSTON COLLEGE

(On behalf of American Association of Community and Junior Colleges, American Association of State Colleges and Universities, American Council on Education, Association of American Universities, Association of Catholic Colleges and Universities, Association of Jesuit Colleges and Universities, Council of Independent Colleges, National Association for Equal Opportunity in Higher Education, National Association of College and University Business Officers, National Association of Independent Colleges and Universities, National Association of Schools and Colleges of

United Methodist Church, and National Association of State Universities and Land-Grant Colleges.)

I am Francis F. Mills, Director of Financing Resources at Boston College. In addition to my specific college duties, I am a member of the Federal Relations Committee of the Association of Jesuit Colleges and Universities, and was recently elected to the Presidency of the Massachusetts Association of Non-Profit Schools and Colleges.

I am pleased to be here to present testimony on behalf of the National Association of Independent Colleges and Universities (NAICU) and the American Council on Education (ACE), representing over 1500 public and independent colleges and universities, as well as the other associations listed on the front page of my testimony. President, Rev. J. Donald Monan, S.J., is currently chairman of the Board of Directors of NAICU.

I ask that a copy of this statement be made part of the record of this hearing.

I would like to express the need for continued availability of tax exempt bond financing for students at independent and public non-profit colleges and universities in the United States because we believe that such financing clearly meets public purpose requirements, and fulfills traditional government objectives.

In the press release which announced the tax-exempt bond hearings, we were pleased to note that fact that student loan and educational facilities bond were not included in H.R. 1635, but were only mentioned in the background portion of the release. The release states, "Private activity tax-exempt bonds are primarily of two types: industrial development bonds and mortgage subsidy bonds. In addition, tax-exempt bonds are issued to finance private, non-profit hospitals and other tax-exempt entities, such as college and universities. Tax-exempt bonds also are used to finance loans for the benefit of students and their parents."

The two pieces of legislation to be focused on today are industrial development bonds and mortgage revenue bonds. We are very pleased that the legislation to date has recognized the distinction between our bonds and private activity bonds. Even though we are not included in current legislation, we would like to express our concerns about tax-exempt bond financing.

Tax-exempt bonds are today utilized for two major purposes in higher education:

1. To obtain capital needed for constructing and renovating educational facilities such as teaching hospitals, dormitories, and student unions, as well as major equipment purchases needed for modernization and research; and

2. To raise capital for student loan programs, to assure that all eligible students will have access to higher education. Student loan bonds are utilized in three ways:

(a) to guarantee loan certainty to students eligible for the federal Guaranteed Student Loan (GSL) program but unable to find a commercial lender willing to make a loan;

(b) to provide a secondary market for GSL's which creates the investment liquidity necessary to encourage the continued participation of lenders in the states; and

(c) to supplement directly the GSL program by providing loans to students and their parents who do not meet the new GSL restrictions and cannot obtain loans from other sources. This latter use provides some relief to students from middle income families who cannot meet the more severe means test created for federal loans but cannot finance their education without borrowing.

For example, within my own state, there exists the Massachusetts Health and Educational Facilities Authority which assists hospitals and colleges in the sale of tax-exempt bonds for the financing of facilities, and the Massachusetts College Student Loan Authority which indirectly assists students by selling tax-exempt bonds to help them finance postsecondary education through the institutions they attend. The Massachusetts Health and Educational Facilities Authority has issued tax-exempt bonds in an aggregate of $1.6 billion since the Authority was first created in 1968. The Massachusetts College Student Loan Authority has made one issue of bonds aggregating a little more than $20 million.

College participants in Student Loan Authority process include: Bentley College, Boston College, Boston University, Hampshire College, Harvard University, Mount Ida College, Simmons College, Wheaton College, and Worcester Polytechnic Institute.

Last year, in the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982, Congress recognized the public purposes that colleges and universities serve, requiring only reporting and registration in the case of student loan bonds or bonds for tax-exempt organizations. We supported those provisions and suggest that no new conditions exist that would indicate a need for further changes in the law. We ask Congress to reassert that recognition and continue the treatment of colleges and universities as stated in TEFRA.

These also has been discussion of ways to limit the issuance of tax-exempt bonds for private activities. Although student loan and educational facilities bonds have been recognized as distinct from private activity bonds, we again would like to express our concerns.

If a state-by-state volume cap were to be implemented and bonds utilized for higher education were to be included, the effects on colleges and universities could be substantial.

Many students travel from their homes to out-of-state colleges. The Guaranteed Student Loan program is available in the state of residence for use where the student attends college. To determine the appropriate state for purposes of a volume cap would be difficult. It also would be difficult to determine annual issuance of bonds for student loans since most are issued every two years for efficiency reasons.

As for facilities bonds, and perhaps in the case of student loan bonds, a state cap also would mean increased cost and delay. An approval process would probably be required, thus delaying construction of essential educational facilities, as well as issuance of loans to students. In addition, the costs associated with such a process would cause great concern for hard-pressed institutions of higher education.

For these reasons, and more importantly, because we have been recognized as distinct from private-purpose bonds, colleges and universities should be excluded from any volume cap.

Student loan bonds are the smallest measurable category of non-government tax-exempt bonds. In FY 1983, student loan bonds will have amounted to only 2.6 percent of all long term tax-exempt issues and 4.5 percent of all non-government-issued tax-exempt bonds.

With regard to bonds for educational facilities and equipment purchases, the revenue gains involved are so small that no government figures on them exist. They are too insignificant in volume for the Treasury to monitor revenue loss—a circumstance directly inverse to their enormous importance to the institution seeking affordable ways to build a dormitory, restore its structural facilities, or modernize its equipment.

The continued availability of tax-exempt facilities financing is extremely important for our institutions. In many cases, it makes the difference between succeeding or failing in a renovation or construction project. It permits institutions to undertake crucial capital improvements outside the fierce grip of current, punishing interest rates. It also fills some of the gap caused by the termination of or reduction in low-interest government facility loan programs. It may allow construction when a project is needed, rather then when fundraising campaigns are concluded. It frequently makes possible renovations which produce more efficient facilities, reducing long-term energy and other operating costs; and many of these savings are directly reflected in lower costs for federally-supported research. And it can permit construction and renovation projects to proceed even in today's depressed building environment, providing desperately-needed stimulation to hard-hit local economies and small businesses.

Teaching hospitals are an especially important use of tax-exempt bonds. Several colleges and universities are in the process of either constructing a new facility or modernizing an existing facility in need of renovation. Those teaching hospitals provide essential educational, research, and health care services, and in addition provide a disproportionate share of Medicaid, Medicare, and charity care. Their public purpose activities are clear.

Student loan bonds are equally as important as facilities financing bonds. Many students seeking assistance under the GSL program are eligible for guaranteed loans but do not have established banking relationships, and therefore have great difficulty obtaining GSL's. Many states don't enjoy the advantage of being money centers with sufficient capital to meet the GSL need by using funds held by commerical lending institutions; these capital-short States cannot meet the full student loan needs of residents without a supplementary source of capital.

Again, Mr. Chairman, we ask that current law as enacted by TEFRA be maintained, requiring both registration and reporting of bonds issued to finance student loans and educational facilities. We further ask that we not be included in any type of volume cap proposal.

Thank you for this opportunity to appear before the Ways and Means Committee on behalf of higher education.

Mr. DOWNEY. Mr. Hawk.

STATEMENT OF RICHARD C. HAWK, CHAIRMAN OF THE BOARD, HIGHER EDUCATION ASSISTANCE FOUNDATION, AND PRESIDENT, NATIONAL COUNCIL OF HIGHER EDUCATION LOAN PROGRAMS

Mr. HAWK. Mr. Chairman and members of the committee, last April I appeared before this committee in opposition to a proposal from the administration which would have restricted use of student loan as well as other tax-exempt revenue bonds. Fortunately, this committee and the Congress had the wisdom and the foresight not to take any action which would have curtailed use of tax-exempt revenue bonds for the purpose of meeting the Nation's needs for guaranteed student loans.

I am confident that the hundreds of thousands of students who every year need to borrow funds to meet the cost of preparing for productive lives are thankful, and that they would like to join in urging you to continue to exhibit the same wisdom and foresight in preserving tax-exempt bonds for student loans.

That April 1982 testimony, which I did attach to my written statement, reminded you that applying additional restrictions on the use of student loan revenue bonds is:

Irrelevant for determining the public purpose of these bond issues, because the public purpose of these single-purpose bonds has already been established;

Unnecessary to avoid a Federal revenue loss, because the Congress has already acted to offset revenue loss from tax exemption on these bonds with a specific reduction in Federal expenditures for loans financed with revenue bonds;

Damaging to the national interest, because the proposal would reduce economic access to education and restrict opportunity for payment of expenses after completion of the education;

And discriminatory against those States which must either depend on revenue bonds to fill the gap between capital which can be provided by commercial lending institutions and the amount of student loan needs or permit a significant portion of the need to go unmet.

In addition to the importance of access to student loans in meeting individual needs of the Nation's youth, which the Congress understands so very well, the underlying purpose of the national effort to make student loans available is essential to future economic as well as social progress of the Nation.

Availability of funds for student loans not only helps students who are willing to help themselves, by providing the means through which the students can assume responsibility for their own education expenses; availability of student loan funds also is an essential stimulus for development of the Nation's human resources, which development has become increasingly critical to the economic health of the Nation.

The increasing importance of better educated and more highly trained talent to economic advancement of the Nation is due in large part to rapid transition from an industrial to an information society. Human resources are more important than either financial or natural resources to economic growth in the kind of knowledge-based, high-technology society emerging in this Nation.

The structural unemployment currently so burdensome on both the affected individuals and the Nation is one manifestation of the transition from an industrial to an information society and of the associated need for more highly trained human resources. Knowledgeable economists have warned that many of the jobs formerly held by the unemployed will never again be available, and that the new jobs which become available will require personnel with different levels of training and skill.

Whether or not the human capital of the type necessary for growth is developed and whether or not individuals acquire the skills to be productively employed workers depends in large part on the extent to which Government policy makes postsecondary education financially accessible to those individuals who need education and training in order to become productive members of the society and whose developed talents are so badly needed for the future economic growth of the Nation.

Mr. Chairman, we think you should reject and resist any restrictions on the use of student loan revenue bonds, because the public purpose of these bonds is clear. The comprehensive statutory provisions in both the Tax Code and the Higher Education Act are sufficiently restrictive. Transfer of loans financed with tax-exempt bonds to taxable resources would require an increase in direct expenditure by the Federal Government for special allowance payments. Curtailing student loan revenue bonds would be discriminatory against those States who do not have adequate capital for this purpose among commercial lenders.

And finally, reduction in accessibility of student loans resulting from restricting the use of tax-exempt bonds would be contrary to the national interest in stimulating opportunity for individuals to prepare themselves as employable contributors to the society and in developing the human resources necessary for economic growth.

Thank you.

[The prepared statement follows:]

STATEMENT OF RICHARD C. HAWK, CHAIRMAN OF THE BOARD, HIGHER EDUCATION ASSISTANCE FOUNDATION [1] AND PRESIDENT, NATIONAL COUNCIL OF HIGHER EDUCATION LOAN PROGRAMS [2]

Mr. Chairman and Members of the Committee, just over a year ago, on April 6, 1982, I appeared before this committee in opposition to a proposal from the Administration which would have restricted use of student loan, as well as other, tax-exempt revenue bonds. Fortunately, this Committee and the Congress had the wisdom and the foresight not to take any action which would have curtailed use of tax-exempt revenue bonds for the purpose of meeting the nation's need for guaranteed student loans. I am confident that the hundreds of thousands of students who every year need to borrow funds to meet the cost of preparing for productive lives are thankful and that they would like to join in urging that you continue to exhibit the same wisdom and foresight in preserving tax-exempt student loan revenue bonds.

That April of 1982 testimony, which is attached, reminded you that applying additional restrictions on use of student loan revenue bonds "is (1) irrelevant for determining the public purpose of these bond issues, because the public purpose of these single purpose bonds has already been established, (2) unnecessary to avoid a federal revenue loss, because the Congress has already acted to offset revenues lost from tax exemption on these bonds with a specific reduction in federal expenditures for loans financed with revenue bonds, (3) damaging to the national interest, because the proposal would reduce economic access to education and restrict opportunity for payment of expenses after completion of the education, and (4) discriminatory against those states which must either depend on revenue bonds to fill the gap between capital which can be provided by commercial lending institutions and the amount of student loan needs or permit a significant portion of the need to go unmet."

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[1] The Higher Education Assistance Foundation serves as the primary student loan guarantee agency in Kansas, Minnesota, Nebraska, West Virginia, Wyoming, and Washington, D.C., and guarantees loans for selected lenders in other locations.

[2] The National Council of Higher Education Loan Programs is a voluntary association of guarantee agencies, statewide direct lending programs and secondary market programs for guaranteed student loans; at least one organization or agency serving these functions for every State is an eligible member.

In addition to the importance of access to student loans in meeting individual needs of the nation's youth, which the Congress understands so very well, the underlying purpose of the national effort to make student loans available is essential to future economic as well as social progress of the nation. Availability of funds for student loans not only helps students who are willing to help themselves by providing the means through which these students can assume responsibility for their own education expenses. Availability of student loan funds also is an essential stimulus for development of the nation's human resources, which development has become increasingly critical to the economic health of the nation.

The increasing importance of better educated and more highly trained talent to economic advancement of the nation is due in large part to rapid transition from an industrial to an information society. Human resources are more important than either financial or natural resources to economic growth in the kind of knowledge-based, high-technology society emerging in this nation.

The structural unemployment currently so burdensome on both the affected individuals and the nation is one manifestation of the transition from an industrial to an information society and of the associated need for more highly trained human resources. Knowledgeable economists have warned that many of the jobs formerly held by the unemployed will never again be available and that the new jobs which become available will require personnel with different levels of training and skill.

Whether or not the human capital of the type necessary for economic growth is developed and whether or not individuals acquire the skills to be productively employed workers depend in large part on the extent to which government policy makes postsecondary education financially accessible to those individuals who need education and training in order to be productive members of the society and whose developed talents are so badly needed for future economic growth of the nation.

Student loan revenue bonds have been a critical part of the federal effort to provide individual opportunity and to develop essential human capital by making postsecondary education financially accessible to those who are willing to help themselves. The structure which the Congress has established for the Guaranteed Student Loan Program is ingenious because it causes effective utilization of private funds and non-governmental expertise, rather than relying on appropriations, to make postsecondary education financially accessible. One important source of those private funds and student loan revenue bonds.

In summary, additional restrictions on use of student loan revenue bonds should be rejected for the following reasons:

(1) The public purpose of student loan revenue bonds is clear.

(2) The comprehensive statutory provisions affecting these bonds (including not only those in the tax code, but also those specific provisions of the Higher Education Act) are already sufficiently restricting.

(3) Transfer of those student loans financed with funds obtained from tax-exempt bonds to funds obtained from taxable sources of funds would entail 100 percent federal special allowance payments, rather than the 50 percent formula amounts curently paid on those loans, thereby requiring a significant increase in direct expenditures by the federal government.

(4) Curtailing student loan revenue bonds would be discriminatory against those states in which adequate student loan capital is not available from commercial lenders.

(5) Reduction in accessibility of student loans resulting from restricting the use of tax-exempt bonds would be contrary to the national interest in stimulating opportunity for individuals to prepare themselves as employable contributors to the economy and in developing the human resources necessary for economic growth.

[Attachment]

STATEMENT OF RICHARD C. HAWK, CHAIRMAN OF THE BOARD, HIGHER EDUCATION ASSISTANCE FOUNDATION, PRESENTED APRIL 6, 1982

(The Higher Education Assistance Foundation serves as the student loan guarantee agency in the states of Kansas, Minnesota, Nebraska, West Virginia, Wyoming and in Washington, D.C.)

Mr. Chairman and Members of the Committee, there are four major reasons why the Department of the Treasury proposal to limit revenue bond tax exemption under Section 103 of the Internal Revenue Code should not be applied to student loan revenue bonds.

I. The public purpose of guaranteed student loans already has been determined by the Congress and adequate limitations on revenue bonds for student loans already exist.

Student loan revenue bonds are issued for the single purpose of obtaining capital for loans to students, or to parents on behalf of students, under the Higher Education Act of 1965, as amended. The Congress has wisely determined that providing economic access to postsecondary education for all eligible citizens, without regard to state of residence, is in the national interest. Indeed, the Congress has established certain federal subsidies to facilitate the availability of loans for eligible students in recognition of the public purpose served by providing a mechanism which permits payment of postsecondary education expenses from earnings after completion of the education.

The Treasury Department proposal for a public hearing and approval process to determine whether or not each bond issue to obtain funds for student loans serves a public purpose is at best an irrelevant procedure, creating an unnecessary expense for the states, and at worst a policy in direct conflict with the broader determination already established by the Congress.

In order to assure the propriety of student loan revenue bond issues and to provide for compliance in utilization of bond proceeds for student loans, the Congress has established specific requirements and restrictions affecting student loan revenue bonds in the Higher Education Act of 1965, as amended. The Higher Education Act requires the maintenance of a "Plan for Doing Business" with the Secretary of Education and annual audits by a certified public accounting firm to assure that bond proceeds are being utilized in accordance with the requirements and criteria specified by the Congress. There is no evidence that the imposition of additional requirements or controls is either necessary or desirable.

II. The Congress already has established a procedure for reducing federal expenditures as an offset against any revenue loss from the tax exemption on student loan revenue bonds.

Although the federal government may lose some potential revenue by permitting interest on student loan revenue bonds to be exempt from federal income tax, the Congress has already established an appropriate arrangement for a compensating reduction in federal expenditures for subsidizing student loans. Quarterly special allowance payments by the federal government to holders of guaranteed student loans are reduced by 50 percent for all guaranteed student loans financed with tax exempt revenue bonds. For the quarter ended December 31, 1981, federal special allowance payments on nine-percent loans not financed with tax exempt bonds were made at the annual rate of 7 percent, while the comparable rate for student loans financed with tax exempt revenue bonds was 3.5 percent. Substituting taxable student loan financing with the corresponding increase in federal expenditures for special allowance payments would serve no useful purpose.

III. Limiting tax exempt revenue bonds as a source of capital for loans originated under the federal Guaranteed Student Loan Program would deprive tens of thousands of postsecondary education students of access to loans for postsecondary education.

Any action to limit the volume of student loan revenue bonds would be counter to the national interest of providing economic access to education for all eligible citizens, because the result of reduced student loan revenue bond volume would be a significant reduction in funds available for student loans. Lack of significant funds for student loans translates directly into denial of economic access to postsecondary education for many eligible citizens.

If the Congress determines that student loan volume should be reduced, such reduction should be achieved through changes in eligibility requirements, maximum loan amounts, or similar provisions which would continue equal opportunity, rather than by action to limit the amount of capital for which eligible citizens would have to compete.

IV. Limiting the use of tax exempt revenue bonds as a supplementary source of capital for guaranteed student loans would penalize those states which already are encountering difficulty in generating adequate funds to meet student loan needs and would place a hardship on the residents of those states.

Some states are in the fortunate position of having sufficient capital to meet the need for guaranteed loans provided entirely by commercial lending institutions. Such fortunate states have not had to use revenue bonds for meeting student loan needs. Other states cannot meet the student loan needs of all residents entirely from funds of commercial lending institutions without a supplementary source of capital. These states have found use of revenue bonds necessary for providing economic access to education for all eligible residents.

The state of Kansas provides a convenient example. About 28 percent ($31 million) of student loans guaranteed in Kansas during fiscal year 1981 was made by the higher Education Loan Program of Kansas, which was established in 1977 as a last resort lender to fill the gap between funds provided by commercial lending institutions and the amount needed to serve all eligible students. The gap exists in spite of a conscientious effort by commercial lending institutions to serve the needs of students while also serving substantial demand for agriculture, business, and other public and private loans. In fact, the annual volume of student loans made by commercial lenders in the state has grown from $10 million in fiscal 1977 to more than $80 million in 1981.

The proportion of the need which must be met through revenue bonds varies among the states. In fiscal 1981, it was 24 percent ($8.9 million) in West Virginia, 47 percent ($104 million) in Minnesota and 77 percent ($38 million) in the District of Columbia. For a student whose need would not have been met without without capital generated from tax exempt revenue bonds the situation is critical, whether the state needs 24 percent or 77 percent.

The effect of the Treasury Department recommendation to require a state contribution to each student loan revenue bond issue would be to penalize those states which are already having difficulty in generating sufficient funds to meet student loan needs. Those states which are fortunate enough to be able to depend solely on capital provided by commercial lending institutions within those states would not be similarly penalized. The states of California, Indiana, Michigan, North Carolina, Oklahoma, South Carolina, and Texas—to mention just a few more—will be affected negatively by the Treasury proposal.

If the Congress determines that availability of student loans should be contingent upon a capital contribution by the state in which the citizen happens to reside, the contribution should be required through a more direct means which would not discriminate against those states which are already experiencing difficulties in generating sufficient capital to meet guaranteed student loan needs.

The Treasury proposal to eliminate arbitrage from investment earnings on bond proceeds and reserve funds would have the same effect as requiring a contribution from each state. Under current economic conditions, elimination of those investment earnings would put capital-short states in the position of either not issuing revenue bonds and not meeting the needs of all students in the state, or making a financial contribution in support of bond issues. The coupon interest rate on student loan revenue bond issues typically is in excess of 9 percent and sometimes exceeds 11 percent under current conditions, because the assured return to the lender on a guaranteed student loan is only 9.5 percent, the lack of opportunity for earnings on investments would destroy the financial feasibility of most student loan revenue bond issues.

SUMMARY

In summary, applying the Treasury Department proposal to student loan revenue bonds is (1) irrelevant for determining the public purpose of these bond issues, because the public purpose of these single purpose bonds has already been established, (2) unnecessary to avoid a federal revenue loss, because the Congress has already acted to offset revenues lost from tax exemption on these bonds with a specific reduction in federal expenditures for loans financed with revenue bonds, (3) damaging to the national interest, because the proposal would reduce economic access to education and restrict opportunity for payment of expenses after completion of the education, and (4) discriminatory against those states which must either depend on revenue bonds to fill the gap between capital which can be provided by commercial lending institutions and the amount of student loan needs or permit a significant portion of the need to go unmet.

Mr. DOWNEY. Mr. Conable.

Mr. CONABLE. I have no questions, Mr. Chairman. Thank you for your testimony.

Gentlemen, as you all note, education as a public purpose seems to be fairly well established.

Mr. HAWK. We agree, Mr. Chairman.

Mr. DOWNEY. To that I would add, the use of these bonds for nonprofit hospitals also appears to be an obvious public purpose, at least to this committee.

Mr. Duncan.

Mr. DUNCAN. I have no questions.

Mr. CONABLE. You know, we have got a lot of pressure on the providers now and I am scared to death that up in my State a lot of schools will be going belly up if we do not in some way mitigate the pressures on them.

I do not know that issuing tax-exempt bonds to meet the cost of cutbacks in public programs is a great idea, because that sounds like kind of a self-defeating project. But I acknowledge that we are going to have to take into special consideration the problems of hospitals.

Mr. DOWNEY. Mr. Owen, I just have one quick question. Appended to your testimony is some brief comments about H.R. 3110 having to do with the Government Tax Leasing Act, and you briefly comment on this measure. Could you tell us what you think the adverse impact of enactment of 3110 would have on the hospitals, on nonprofit hospitals?

Mr. OWEN. All right. In some cases we have discovered there are companies that are leasing equipment to hospitals through this mechanism, and if they lost that, the price of the lease would go up and therefore the expenditure of the hospital would go up. That is the most we can find.

The hospital itself is not that much involved in it, except those industries who lease equipment to the hospitals. That does make a difference.

Mr. DOWNEY. I want to thank the members of the panel for your testimony. Thank you very much.

The committee will next hear from those members who are interested in agriculture: N. Rollie Lake, Kent Jones, Ronald Bean, and Steven Jelin.

Some are interested in agriculture and others in retailing, and another in environmental facilities financing. I would not want to lump pollution control financing in with agriculture and associate you in any pejorative fashion. Agriculture is great, pollution is not great, but doing away with it is a wonderful thing, just so we have our bases covered.

Mr. Lake, we will hear from you first.

STATEMENT OF N. ROLLIE LAKE, PRESIDENT, COMMUNICATING FOR AGRICULTURE, INC., ACCOMPANIED BY BILL ADAMS, VICE PRESIDENT

Mr. LAKE. Thank you. Mr. Chairman and members of the committee.

My name is Rollie Lake and I want to thank you for the opportunity to speak on H.R. 1635, the Industrial Development Bond Limitation Act, which contains a provision to prohibit the use of small issue industrial development bonds for the purchase of land, including land for agricultural purposes.

I am president of Communicating for Agriculture, a national, nonpartisan, nonprofit rural advocacy organization. I am also senior vice president and director of the First National Bank of Fergus Falls, Minn., specializing in agricultural credit. In addition, I am vice president and director of the Minnesota Independent Bankers' Credit Corp., which obtains agricultural lending funds from the open market through the Federal Intermediate Credit Bank.

CA has become deeply involved in the IDB issue and has traveled throughout the United States on behalf of State programs designed to assist qualified farmers and ranchers to begin their agricultural careers. CA has become known as one of the Nation's leading authorities in beginning farmer-rancher programs.

This past December, CA hosted a national conference and State agricultural finance programs, attended by agriculture and financial lenders from all parts of the United States. CA receives and responds to questions from all over the Nation on agricultural credit, both from those who are in need of it and from State and national officials who are formulating programs to assist qualified beginning farmers and ranchers.

The views which I express today as president of the Communicating for Agriculture are shared by the Iowa Family Farm Development Authority, the Illinois Farm Development Authority, the Nebraska Agricultural Development Corp., the Center for Rural Affairs, and the National Farm Coalition.

The National Farm Coalition, whose membership includes more than 20 national agricultural and commodity groups, adopted a resolution on May 24, 1983, endorsing the continued use of industrial development bonds for agricultural purposes directed toward qualified beginning farmers and ranchers.

CA supports the basic thrust of H.R. 1635. We understand the growing concern about the mushrooming use of industrial development bonds for private purposes. We agree that agriculture's use of industrial development bonds to purchase farm and ranch land should be limited. However, we do not feel that agriculture's use of industrial development bonds to purchase farm and ranch land should be eliminated altogether, as proposed in H.R. 1635.

Several States have established good IDB programs with solid track records of helping young people get started in agriculture. These young people are now established and have become productive producers, contributing to the positive balance of payments that this country enjoys in agriculture.

In 1980 through 1983, IDB-based agricultural loan programs were created in 19 States and some are now successfully underway. Admittedly, not all of the state programs are directed toward beginning farmers and ranchers. However, some have appropriate borrowing requirements and safeguards against abuse and are well targeted toward people who need assistance to get started in agriculture.

The Iowa Family Farm Development Authority is an excellent example. It specializes in authorizing participating financial institutions to make direct loans with loans generated from the sale of IDB's, for use by beginning farmers with net worths less than $100,000. The Iowa program has served as a model for several other state programs.

CA members throughout the country strongly feel that all IDB-based agricultural loan programs for land purchase should be targeted toward qualified beginning farmers and ranchers who cannot get reasonable financing through conventional nongovernmental sources. CA has explored with State officials throughout the country several possible amendments to H.R. 1635 which would allow the benefits of industrial development bond financing for agricultural land purchase, yet at the same time curtail the mushrooming use of tax-exempt financing and eliminate the abuses many people feel occur in industrial development bond financing.

CA proposes that agriculture be allowed to use small issue industrial development bonds for the purchase of land for agricultural purposes, with the following additional limitations:

First-time farmland purchase or ownership test: Financing would be restricted to the first-time acquisition or ownership of agricultural land by the user.

Capital expenditure test: Financing would be available only to individuals who have not expended more than $100,000 of capital expenditures in the 3 years preceding the date of issuance of the bonds.

Gross income test: Financing would be available only to an individual whose gross income does not exceed the $150,000 for each of the 3 years preceding the date of the issuance of the bonds.

The engaged in farming test: The fourth test, to be applied simultaneously with the foregoing three tests, would be that financing only be available for an individual who actually intends to be engaged in farming or has been engaged in farming.

Again, CA supports the basic thrust of H.R. 1635. We feel that there is an appropriate place for agriculture's use of industrial development bonds for qualified beginning farmers and ranchers.

How the committee decides this issue will have a tremendous impact on who will and who will not be in farming in future years. Currently, the average American farmer's age is in the upper fifties. We need to help a new generation get started as the current generation retires. If we do not do this, we run the risk of seeing American agriculture seriously deteriorate, with a resulting loss of our position in world trade.

I have with me today Bill Adams, our vice president, who will help answer any questions you should have, and I want to thank you for the opportunity.

[The prepared statement follows:]

STATEMENT OF N. ROLLIE LAKE, PRESIDENT, COMMUNICATING FOR AGRICULTURE, INC.

Mr. Chairman, members of committee: My name is N. Rollie Lake and I thank you for the opportunity to speak on H.R. 1635, the Industrial Development Bond Limitation Act, which contains a provision to prohibit the use of small issue industrial development bonds for the purchase of land, including land used for agricultural purposes.

I am president of Communicating for Agriculture (CA), a national, nonpartisan, nonprofit rural advocacy organization. I am also senior vice president and director of the First National Bank of Fergus Falls, Minn., specializing in agricultural credit.

In addition, I am vice president and director of the Minnesota Independent Bankers' Credit Corporation, which obtains agricultural lending funds from the open market through the Federal intermediate credit bank.

The views which I express today as president of Communicating for Agriculture are shared by the Iowa Family Farm Development Authority, the Illinois Farm Development Authority, the Nebraska Agricultural Development Corporation, the Center for Rural Affairs, and the National Farm Coalition. The National Farm Coalition, whose membership includes more than 20 national agricultural and commodity groups, adopted a resolution on May 24, 1983, endorsing the continued use of industrial development bonds for agricultural purposes, oriented toward qualified beginning farmers and ranchers.

CA supports the basic thrust of H.R. 1635. We understand the growing concern about the mushrooming use of industrial development bonds for private purposes. We can support the provisions in H.R. 1635 which propose the elimination of tax exemption for industrial development bonds issued with FSLIC/FDIC insurance. We agree that agriculture's use of industrial development bonds to purchase farm and ranch land should be limited. However, we do not feel that agriculture's use of industrial development bonds to purchase farm and ranch land should be eliminated altogether, as proposed in H.R. 1635.

Communicating for Agriculture feels strongly that there is an appropriate use of industrial development bonds in agriculture, and that use is to assist qualified beginning farmers and ranchers.

Communicating for Agriculture bases its coals and activities on information provided by its members, who are farmers, ranchers and rural business people through resolutions and surveys. Consistently ranking at the top of our surveys is the need to support ways through which qualified young people can get started in farming and ranching.

As a result, CA has become deeply involved in this issue and has travelled throughout the United States on behalf of State programs designed to assist qualified beginning farmers and ranchers to begin their agricultural careers. CA has become known as one of the Nation's leading authorities on beginning farmer-rancher programs. This past December, we hosted a National Conference on State Agricultural Finance Programs, attended by agricultural and Financial lenders from all parts of the United States. We regularly receive and respond to questions from all over the Nation on agricultural credit, both from those who are in need of it and from State and national officials who are formulating programs to assist qualified beginning farmers and ranchers.

Qualified beginning farmers and ranchers are the people on whom the future of United States agriculture depends. Today, beginning farmers and ranchers find themselves in a position where they have the skills, the training and the determination to become the Nation's and the world's most productive farmers and ranchers, but they have not yet established credit to acquire the land and materials needed before they can get underway. They have not yet had the opportunity to establish a base of credit with which they can obtain loans, and so they require special programs oriented toward their special needs.

Several States have established such programs, and some of them have established good, solid track records of helping young people get started in agriculture. These young people are now established and have become productive producers contributing to the positive balance of payments this country enjoys in agriculture.

The first two States to establish such programs, Minnesota and Hawaii, did so when the economy was far more positive and used direct State appropriations. During the past several years, the economy has not allowed States sufficient funds to make State appropriations for such programs. Thus, most States who have recently adopted beginning farmer or agricultural programs have utilized tax-exempt industrial development bonds.

In 1980 through 1983, IDB based agricultural loan programs were created in 19 States, and some are now successfully underway. Admittedly, not all of the State programs are oriented toward beginning farmers and ranchers. However, some have appropriate borrowing requirements and safeguards against abuse and are well targeted toward people who need assistance to get started in agriculture.

The Iowa Family Farm Development Authority is an excellent example. It specializes in authorizing participating financial institutions to make direct loans, with funds generated from the sale of IDBs to beginning farmers with net worths of $100,000 or less. The Iowa program does not use composite issues. Yet, it has been very successful; and to date, 282 beginning farmer loans, of $21,013,443, and 15 conservation loans, of $74,250, have been approved through it. The Iowa program has served as a model for several other State programs.

Other States have programs that show much promise. The activities of the Illinois Farm Development Authority and the Nebraska Agricultural Development Corporation are off to a good start. The developing programs in Indiana, Montana, Michigan, South Carolina, and Georgia are among the State programs which are very well put together and could be of great benefit to developing a future generation of top agriculture producers.

A list of all State IDB based agricultural loan programs is included as addendum A to this testimony.

Again, I emphasize that Communicating for Agriculture is certainly in sympathy with the current concern about the potential overuse and abuse of industrial development bonds. CA is very much in agreement that appropriate limitations should be placed on IDB financing.

For agricultural purposes, CA members throughout the country strongly feel that all IDB based agricultural loan programs for land purchased should be targeted toward qualified beginning farmers and ranchers who cannot get reasonable financing through conventional non-governmental sources.

In agriculture, allowing all categories of farmers and ranchers to have access to IDB-based loans for land purchases would actually be detrimental rather than helpful to beginning farmers and ranchers. Because land is a finite resource, it would further limit qualified beginning farmers and ranchers to enter the land market because it would inflate land prices. It would increase the difficulty in obtaining credit because it would place beginning farmers and ranchers in competition with established, high-equity farmers and ranchers who would invariably be able to out bid them.

Communicating for Agriculture believes that the solution to this is not elimination of agriculture's use of industrial development bonds to purchase land, communicating for agriculture believes that the solution is to provide specific language which would target the use of IDBs to qualified beginning farmers and ranchers.

We have explored with State officials throughout the country several possible amendments to H.R. 1635 which would allow the benefits of industrial development bond financing for agricultural land purchase, yet curtail the mushrooming use of tax-exempt financing and eliminate the abuses many people feel occur in industrial development bond financing.

We propose that agriculture be allowed to use small issue industrial development bonds for the purchase of land for agricultural purposes with the following additional limitations:

1. First time farm land purchase or ownership test. Financing would be restricted to the first time acquisition or ownership of agricultural land by the user.

The first time user concept is presently incorporated in the Ullman bill relating to mortgage subsidy bonds, now codified in section 103A of the Internal Revenue Code.

2. Capital expenditure test. Financing would be available only to individuals who have not expended more than $100,000 of capital expenditures in the three years preceding the date of issuance of the bonds.

As a program to target individuals in the process of starting farming who need assistance, one of the tests should relate to financial ability. A test presently incorporated in section 103 of the Internal Revenue Code relating to industrial revenue financing is a capital expenditure test. For the purposes of this test, only capital expenditures attributable to the individual would be included.

We have examined farm recordkeeping materials from several States, and the materials from Iowa are contained in Addendum B of this testimony. This test can be substantially monitored by the Internal Revenue Service from form 1040 filings.

3. Gross income test. Financing would be available only to an individual whose gross income does not exceed $150,000 for each of the three years preceeding the date of issuance of the bonds.

The gross income test is presently incorporated in tests associated with mortgage subsidy bonds. For agriculture, USDA studies show that the optimum size family farm is around $150,000 of gross income. The test can be substantially monitored by the Internal Revenue Service from form 1040 filings.

4. Engaged in farming test. The fourth test to be applied simultaneously with the foregoing three tests would be that the financing only be available for an individual who actually intends to be engaged in farming or has been engaged in farming. This test is currently included in a number of existing State programs and further eliminates the possible abuse of industrial revenue bond financing for land purchases by investors and could be monitored through the filing of form 1040, schedule F.

We have engaged in a great deal of discussion with State officials from throughout the country during the past several months which have led to the foregoing recommendations. We ask that the committee incorporate them into H.R. 1635 to allow industrial development bond financing for loans to qualified beginning farmers and ranchers for the purchase of land.

Once again, CA supports the basic thrust of H.R. 1635. We feel that there is an appropriate place for agriculture's use of industrial development bonds for qualified beginning farmers and ranchers.

How the committee decides this issue will have a tremendous impact on who will and who will not be in farming in future years. Currently, the average American farmers' age is in the upper 50's. We need to help a new generation get started as the current generation retires. If we do not do this, we run the risk of seeing American agriculture seriously deteriorate with a resulting loss of our position in world trade.

We ask the serious consideration by the committee of the proposals which we have offered.

If the committee has any questions, we would be glad to answer them. I have with me today Bill Adams, who is vice president of Communicating for Agriculture, and who has travelled throughout the United States working with beginning farmer and rancher programs. Either of us would be happy to answer any questions you might have.

Thank you for this opportunity to address this important issue.

ADDENDUM A
TESTIMONY BEFORE THE COMMITTEE
ON WAYS AND MEANS
ON THE INDUSTRIAL DEVELOPMENT BOND
LIMITATION ACT (HR 1635)

JUNE 15, 1983
WASHINGTON, D. C.

STATE AGRICULTURAL FINANCE PROGRAMS USING INDUSTRIAL DEVELOPMENT BONDS
PREPARED BY: COMMUNICATING FOR AGRICULTURE, INC.
May 11, 1983

STATE	ELIGIBILITY-NET WORTH TEST		LOAN SIZE LIMITATIONS	PROGRAM SIZE	BONDS ISSUED	LOANS MADE	DATE LEGISLATION ENACTED
Alabama	None	First Issue:	$400,000 per Agriculture Commission (not part of legislation enacted)	No Limits	* $35 Million Composite Issue	$3 Million	1980
		Second Issue: (1983)	None		$6 Million Composite Issue	Unable To Determine	
Colorado	None	(4/83)	None	No Limits	$8 Million Composite Issue	Unable To Determine	1981
Georgia	$100,000 Net Worth (excluding land)		None	$100 Million	None	None	1980
Illinois	None - Board adopted $250,000 net worth		$100,000 for any single real estate loan	$50 Million	$5.5 Million Individual Issue	$5.5 Million	1981
Indiana	Legislative Intent For Beginning Farmers		None	No Limits	None	None	1981
Iowa	$100,000 Net Worth		$500,000 Farmland $125,000 Depreciable Assets	$150 Million	$7 Million Individual Issue	$7 Million	1980, 1981
Kansas	None		None	No Limits	None	None	No Legislation Required
Louisiana	None		Used FmHA Loan Program Guidelines	No Limits	* $25 Million Composite Issue	$3 Million	No Legislation Required
Michigan	$250,000 Net Worth		$400,000 Farmland $125,000 Depreciable Assets	$100 Million	None	None	1982
Minnesota	None		None	$30 Million	None	None	1982 Ammendment to Minn. Small Business Finance Agency

STATE AGRICULTURAL FINANCE PROGRAMS USING INDUSTRIAL DEVELOPMENT BONDS
PREPARED BY: COMMUNICATING FOR AGRICULTURE, INC.
May 11, 1983

STATE	ELIGIBILITY-NET WORTH TEST		LOAN SIZE LIMITATIONS	PROGRAM SIZE	BONDS ISSUED	LOANS MADE	DATE LEGISLATION ENACTED
Missouri	None		None	No Limits	None	None	1981
Montana	$150,000 Net Worth		None	$200 Million	None	None	1983
Nebraska	$300,000 Net Worth	(4/83)	$500,000	No Limits	$4.5 Million Composite Issue $3.7 Million Individual Issue	$4.5 Million $3.7 Million	1981
North Dakota	None	(3/83)	None	No Limits	$16 Million Composite Issue	Unable To Determine	1981
Oklahoma	None	First Issue:	Used FmHA Loan Program Guidelines	No Limits	* $50 Million Composite Issue	$18 Million	No Legislation Required
		Second Issue: (1983)	None	No Limits	$29 Million Composite Issue	Unable To Determine	
South Carolina	Adjusted Gross Income Less Than or Between 75 & 125% of Median Gross Incomes for South Carolina		None	No Limit	None	None	1981
South Dakota	None		None	No Limit	None	None	1983
Tennessee	Otherwise unable to obtain credit at reasonable rate - one bank turn-down		$500,000	$30 Million	None	None	1981
Virginia	None		None	No Limit	$1.5 Million Composite Issue	Unable To Determine	1981

* (Most recalled---loans could not meet FmHA credit elsewhere tests.)

ADDENDUM B
TESTIMONY BEFORE THE COMMITTEE
ON WAYS AND MEANS
ON THE INDUSTRIAL DEVELOPMENT BOND
LIMITATION ACT (HR 1635)

JUNE 15, 1983
WASHINGTON, D. C.

STUDY OF THIRTY-SEVEN RANDOMLY SELECTED IOWA FARM TAX RETURNS
PREPARED BY: COMMUNICATING FOR AGRICULTURE, INC.

NET WORTH OF TAXPAYER	CAPITAL EXPENDITURES, THREE YEAR ANNUAL AVERAGE RANGE[1]
Under $ 100,000	$ 10,395 - $ 31,151
$100,000 - $ 400,000	$ 7,903 - $ 34,071
$400,000 - $1,000,000	$ 16,390 - $ 64,879
Over $1,000,000	$ 37,480 - $122,732

[1] Does not include any capital expenditures for land purchases. Of the thirty-seven returns, only three had purchased land during the previous three years.

Mr. **Downey**. Thank you very much, Mr. Lake, for your testimony.

Mr. Jones, agriculture commissioner from the State of North Dakota.

Mr. Dorgan, would you like to welcome——

Mr. **Dorgan**. Mr. Chairman, let me welcome Mr. Jones to the committee and point out for the record that Mr. Jones is a former State senator in North Dakota, now serves as commissioner of agriculture in North Dakota, and in that position, serves on the industrial commission; and that industrial commission, comprised of the Governor, the commissioner of agriculture, and one other official, is involved in a number of bond issues, including agriculture bond issues and mortgage subsidy bond issues and so on, and we want to welcome Mr. Jones to the committee.

Mr. **Downey**. Thank you.

Mr. Jones.

STATEMENT OF KENT JONES, COMMISSIONER, NORTH DAKOTA DEPARTMENT OF AGRICULTURE, AND MEMBER, NORTH DAKOTA INDUSTRIAL COMMISSION

Mr. **Jones**. Thank you, Mr. Chairman, Congressman Dorgan, and committee members.

Farming, as you well know, has had some very, very tough times in the last few years. This is certainly true in North Dakota. We have suffered through droughts, we have suffered through depressed prices, but I think one of the biggest problems we have is our high interest rates. They are, in effect, killing us. We estimated in our North Dakota Department of Agriculture that some 900 farmers in 1983 are facing bankruptcy, and high interest rates are certainly one of the things causing the crisis.

Accordingly, the State legislature authorized us to go out and do an agri-bond issue. The Industrial Commission, all of us whom are elected, made the motion to go ahead and do it, and my department ran that issue. And now we have some specs on it. You can get a little information on what effect it had across the State of North Dakota, and these are the things I am going to try to bring out.

First of all, the equipment and livestock part of it came to the farmers' cost at 8.8 percent. For farmland and buildings it came in at 9.6 percent, and again, this includes the bank's 1½ percent.

But the interesting thing was that pretty near 79 percent of those loans were under $50,000. The average loan to those farmers and ranchers in North Dakota was $40,000. Gentlemen, this means that if they had a tractor, or cultivator, or drill, that they desperately needed to trade, or if they needed to improve the bloodlines on their livestock, they could not do it because of the high interest rates. And now, because of the availability of the agri-bonds, they indeed went out and made these types of trades.

This means a multiplier effect, of course, directly with the Main Street businesses. Instead of having a cultivator, a good used cultivator or a new cultivator sitting there, they went out and made the trade and it had a definite effect, because as the farmers are having troubles—and I am a farmer, I understand it—as they are having troubles, then they do not do the buying. So, we have the businesses on Main Street suffering just as much or more as the farmers are themselves.

We also have had a 5-percent decrease in our land valuation. This is very bad for us when we are in this strapped situation because it reduces the amount of equity that a farmer has, to keep himself afloat. This is the name of the game now in agriculture in North Dakota and other States—to keep our farmers afloat until the recovery comes around.

The fact that land is mentioned specifically in H.R. 1635 means that we would not be able to use this type of bond for land change. Now, we did not have a great number of farmers participating in buying land and using our agri-bond issue; nevertheless, this would have an effect on maintaining the land value so that they could maintain their borrowing capabilities.

The other thing that is interesting, listening to the testimony that you gentlemen have had today, is that there are no large corporations involved in this. In fact, there are no corporations because corporations are not allowed to own land in North Dakota, for one thing. But it was just intended to, and did indeed, help keep farmers on the land, to keep them in the business, and also, of course, to help the basic bread and butter industry, the farmers and ranchers themselves. It did just that.

One thing we are in opposition to on 1635 is the land, but the even larger thing is the restriction on FDIC and on FSLIC backing. This is an integral part of our agri-bonds. It is why we managed to come out with an AAA rating, and get such a good interest rate, and it would severely cripple any future agri-bond programs by causing the interest rates to be raised and therefore not be of help to our farmers and ranchers.

Gentlemen, I want to thank you for this opportunity to appear before you. I ask you very sincerely, agriculture needs to be continued on. We are the first in trouble as far as the economy is concerned. We are the last out. We need to maintain our farmers on our farms. Agri-bond certainly is a viable self-help, paying proposition for not only farmers and ranchers, but increased business.

Thank you.

[The prepared statement follows:]

STATEMENT OF HON. H. KENT JONES, AGRICULTURE COMMISSIONER, STATE OF NORTH DAKOTA

MR. CHAIRMEN AND MEMBERS OF THE HOUSE WAYS AND MEANS COMMITTEE, I BRING YOU GREETINGS FROM THE GREAT STATE OF NORTH DAKOTA!

MY NAME IS KENT JONES, I AM AGRICULTURE COMMISSIONER FOR THE STATE OF NORTH DAKOTA -- A POSITION I WAS ELECTED TO IN 1980. IN THAT CAPACITY, I ALSO SERVE WITH GOVERNOR ALLEN OLSON AND ATTORNEY GENERAL ROBERT WEFALD ON OUR STATE'S INDUSTRIAL COMMISSION -- A STATE ENTITY CHARGED WITH THE RESPONSIBILITY FOR THE EFFECTIVE AND ORDERLY DEVELOPMENT OF THE ECONOMIC WELL-BEING OF OUR STATE AND ITS CITIZENS.

FIRST, MAY I THANK YOU FOR THE OPPORTUNITY TO APPEAR BEFORE YOU TO DISCUSS THE FUTURE OF AGRICULTURE AND AGRI-BUSINESS IN BOTH NORTH DAKOTA -- AND, INDEED, ACROSS THE COUNTRY!

NORTH DAKOTA, AS CONGRESSMAN DORGAN CAN ATTEST, IS THE MOST AGRICULTURAL STATE IN THE UNION. OF OUR POPULATION, ONE IN EVERY SIX FAMILIES IS EMPLOYED DIRECTLY IN THE BUSINESS OF -- FARMING AND RANCHING -- MEANWHILE AGRICULTURE GENERATES OVER HALF OF THE GROSS BUSINESS VOLUME IN THE STATE

AS YOU ARE WELL AWARE, FARMERS AND OUR AGRICULTURAL ECONOMY HAVE HAD THEIR PROBLEMS IN RECENT YEARS. THE STORY IS A FAMILIAR ONE -- A RECESSION, COMMODITY SURPLUSES, DEPRESSED PRICES, INCREASING PRODUCTION COSTS AND HIGH INTEREST RATES -- ALL SERVING TO UNDERMINE THE BREAD AND BUTTER INDUSTRY OF OUR STATE -- AND OUR NATION.

PROJECTIONS INDICATE THAT PERHAPS AS MANY AS 900 FARMERS AND RANCHERS WILL DECLARE BANKRUPTCY IN 1983 -- AN INCREASE OF NEARLY 400-PERCENT FROM 1982. I AM SURE YOU CAN SEE THE FARMERS' AND RANCHERS' ECONOMIC PLIGHT WHEN, AMONG OTHER COSTS, INTEREST COSTS -- AS A PERCENTAGE OF INCOME -- HAS MORE THAN DOUBLED IN A TWO-YEAR PERIOD.

OBVIOUSLY, THESE CURRENT CONDITIONS CAN NOT BE ALLOWED TO CONTINUE. OUR NATIONAL INTEREST DEMANDS THAT FARMERS NO LONGER BE THE PIVOT POINT ON WHICH CONGRESS ATTEMPTS TO BALANCE THE FEDERAL BUDGET. CONGRESS SIMPLY CAN NO LONGER ATTACK THE BREAD AND BUTTER INDUSTRY OF THIS NATION IN ORDER TO SOLVE ITS BUDGET PROBLEMS.

GENTLEMEN, WE'RE TRYING -- AT A STATE LEVEL -- TO HELP FARMERS. ONE FORM OF THAT HELP CAME ABOUT WHEN THE 1981 SESSION OF OUR STATE LEGISLATURE AUTHORIZED THE INDUSTRIAL COMMISSION TO ISSUE AND SELL AGRICULTURE REVENUE BONDS. A REVENUE PRODUCING SYSTEM THAT HAS -- AND IS -- A PROVEN "SELF-HELP" PROGRAM FOR FARMERS.

IN MARCH OF THIS YEAR, WE ISSUED OUR FIRST BONDS. IN A YEAR OF "DOOM AND GLOOM," THE AGRI-BOND IS ONE OF THE FEW BRIGHT SPOTS. UNDER OUR BOND PROGRAM, 18-MILLION DOLLARS IN TAX-EXEMPT REVENUE BONDS WERE SOLD BY THE STATE. THIS, IN TURN, HELPED 388 NORTH DAKOTA FARMERS AND RANCHERS WITH LOANS FOR MACHINERY, LIVESTOCK, AND LAND.

THE LOANS WERE MADE TO FARMERS AT AN INTEREST RATE OF 8.8-PERCENT FOR EQUIPMENT AND LIVESTOCK, WHILE LOANS FOR FARM LAND WERE MADE AT 9.6-PERCENT. CONSIDERING TODAY'S MARKET RATE OF INTEREST, THE BONDS WILL SAVE NORTH DAKOTA FARMERS AND RANCHERS ABOUT 636-THOUSAND DOLLARS IN INTEREST PAYMENTS FOR THE FIRST YEAR ALONE. ONLY 22 LOANS -- OR 5.7-PERCENT -- OF THE 388 WERE MADE IN EXCESS OF 100-THOUSAND DOLLARS. 78.6-PERCENT -- OR 305 LOANS -- WERE MADE FOR UNDER 50-THOUSAND DOLLARS.

CLEARLY, THIS IS A PROGRAM THAT DOES NOT BENEFIT LARGE CORPORATIONS, BUT ONE THAT HAS BECOME -- AND IS -- ESSENTIAL TO FARMERS, RANCHERS, AND SMALL-TOWN AMERICA.

I AM IN AGREEMENT WITH HOUSE BILL 1635 INSOFAR THAT "LARGE CORPORATIONS" WHICH ARE ABLE TO SECURE ADEQUATE AND AFFORDABLE FINANCING BE PROHIBITED FROM SECURING INDUSTRIAL DEVELOPMENT BOND FUNDING.

HOWEVER, WHEN A STATE SUCH AS NORTH DAKOTA IS ABLE TO PROVIDE THE SMALL AGRI-BUSINESSMAN WITH LOW INTEREST FINANCING TO PURCHASE EQUIPMENT AND LAND NEEDED TO CONTINUE IN BUSINESS -- EACH OF US HAS A RESPONSIBILITY TO PROVIDE THAT FINANCING.

IN ACCEPTING THAT RESPONSIBILITY, WE ARE REVIVING NOT ONLY THE FAMILY FARM, BUT -- AS YOU CAN SEE -- MAIN STREET BUSINESSES IN COMMUNITIES ACROSS OUR STATE -- AND IN EVERY STATE PARTICIPATING IN AGRI-BOND PROGRAMS.

IF I MAY, I'D LIKE TO DRAW YOUR ATTENTION TO THE POTENTIAL MULTIPLIER EFFECT OUR 18-MILLION DOLLAR BOND CAN HAVE ON OUR STATE'S ECONOMY. USING AN AVERAGE MULTIPLIER -- 3-POINT-7 (FOR THESE TYPES OF DOLLARS) -- OUR ECONOMY CAN APPRECIATE A ROLL-OVER TOTALLING MORE THAN 58-MILLION IN NEW REVENUE FOR THE TERM OF THE BOND ISSUE.

THAT IS 58-MILLION DOLLARS THAT IS HELPING MAIN STREET BUSINESSES STAY IN BUSINESS -- CONTINUING TO PAY TAXES -- CONTINUING TO PAY EMPLOYEES -- WHO CONTINUE TO PAY TAXES. IT IS 58-MILLION DOLLARS THAT IS HELPING TO KEEP EMPLOYERS AND THEIR EMPLOYEES OFF THE WELFARE ROLLS.

THIS YEAR, THE VALUE OF NORTH DAKOTA'S FARM LAND DECREASED FIVE PERCENT -- THIS IS THE FIRST DECREASE IN FARM LAND VALUES IN OUR STATE SINCE 1954! THIS DECREASE HAS PRODUCED AN EQUITY LOSS TOTALLING NEARLY 920-MILLION DOLLARS. AS CONGRESSMAN DORGAN, AND MANY OTHERS ARE AWARE, THIS IS DEVASTATING TO NORTH DAKOTA AND OTHER FARM-BELT STATES.

CONSIDERING ALL THE AGRICULTURAL ECONOMIC DISASTERS I'VE DESCRIBED, I SINCERELY HOPE YOU GENTLEMEN CAN SEE THAT AGRI-BONDS ARE A WORKABLE -- AND SENSIBLE -- SYSTEM OF PROVIDING A NEEDED "BOOSTER SHOT" IN THE ARM FOR OUR ECONOMY. AGRI-BONDS PROVIDE FIXED RATE, LOW-INTEREST FINANCING THAT ENABLES FARMERS TO PURCHASE ADDITIONAL LAND. PURCHASES THAT MAINTAIN THE VALUE OF THE LAND AND ALSO MAINTAIN THE FARMER'S EQUITY.

UNDERSTANDABLY, BANKS AND OTHER FINANCIAL INSTITUTIONS ARE RELUCTANT TO PROVIDE FIXED-RATE LOANS FOR MORE THAN A COUPLE OF YEARS. "BOUNCING BALL" FEDERAL RATES HAVE TAKEN THEIR TOLL IN LOSSES FOR BANKERS -- AND THEY'RE SIMPLY NOT GOING TO ... AND CAN'T AFFORD TO -- LOSE ANY MORE MONEY FROM FIXED RATE, LONG-TERM LOANS.

SINCE THE SUCCESSFUL SALE OF OUR AGRI-BONDS IN MARCH, THE DEPARTMENT OF AGRICULTURE HAS BEEN BESIEGED WITH CALLS FROM FARMERS AND RANCHERS REQUESTING A SECOND BOND SALE. OBVIOUSLY THE ADOPTION OF HOUSE BILL 1635 IN ITS PRESENT FORM WOULD CERTAINLY KILL ANY FURTHER PROGRAMS OF THIS TYPE.

AS YOU CONSIDER THE COMMENTS I'VE MADE HERE TODAY, PLEASE REMEMBER I DO NOT OPPOSE THAT PORTION OF THE RESOLUTION PREVENTING LARGE CORPORATIONS TAKING ADVANTATE OF INDUSTRIAL DEVELOPMENT BONDS. BUT, I CANNOT AND WILL NOT CONCUR WITH ADOPTION OF ANY MEASURE THAT IS CONTRARY TO THE BEST INTERESTS OF OUR NATION'S LARGEST INDUSTRY -- AN INDUSTRY OF SMALL BUSINESSES -- OUR NATION'S FARMERS.

I WANT TO MAKE IT CLEAR THAT I FEEL INDUSTRIAL BONDS, BACKED BY THE F.D.I.C. NAD THE F.S.L.I.C., ARE FILLING A TREMENDOUS NEED -- NOT ONLY IN PROVIDING LOWER INTEREST RATE LOANS, BUT ALSO IN REDUCING OUR FEDERAL DEFICIT.

GENTLEMEN, I'M SURE THE AMERICAN FARMER APPRECIATES THE CONCERN YOU HAVE GIVEN HIM TODAY. ON BEHALF OF "THE AMERICAN FARMER," I THANK YOU FOR THE OPPORTUNITY TO PARTICIPATE IN THIS HEARING.

Mr. PICKLE [presiding]. Thank you, Mr. Jones.

Now we will hear testimony from Mr. Ronald Bean, president of the Council of Pollution Control Financing Agencies of Illinois.

Mr. Bean.

STATEMENT OF RONALD BEAN, PRESIDENT, COUNCIL OF POLLUTION CONTROL FINANCING AGENCIES, AND EXECUTIVE DIRECTOR, ILLINOIS ENVIRONMENTAL FACILITIES FINANCING AUTHORITIES

Mr. BEAN. Thank you, Mr. Chairman.

Members of the committee, I am Ronald Bean, executive director of the Illinois Environmental Facilities Financing Authority. I appear before this committee as president of the Council of Pollution Control Financing Agencies.

Mr. Chairman, proposals to restrict the use and availability of IDB's for pollution control financing fail to recognize the critical and distinct purpose of PCIDB's. H.R. 1635 would deny ACRS benefits in conjunction with the use of PCIDB's. ACRS benefits are specifically for the company that is modernizing to assure its capital investments do not act as an economic drag on the company. PCIDB's provide the means for a company to ease the costs associated with the nonproductive nature of pollution control expenditures and enhance its economic viability. Pollution control costs do not add to a company's assets.

Pollution control expenditures are a nonproductive expenditure in the sense that pollution control facilities do not increase a firm's productivity However, these expenditures are mandated to serve a public purpose, provide a clean environment. It is critical to note these investments are required by law. No distortion in resource allocation occurs, except an effort to meet a desired and mandated public goal, clean air, water and land.

The U.S. Department of the Treasury and PCIDB critics have argued that these bonds deprive the Federal Treasury of much needed revenues because of their tax-exempt nature. A study the Council of Pollution Control Financing Agencies commissioned stated that additional tax revenues would not be gained from further PCIDB restrictions. And I would like to submit a copy of that study for the record.

The study stated investors who would ordinarily purchase PCIDB's will seek other tax shelters to invest resources. Thus, the study concluded, in order to increase the Treasury's revenues, it would be necessary to eliminate all existing tax shelters.

In addition, businesses who depend on PCIDB's would be forced to rely on taxable capital. This circumstance would increase a business' tax interest deduction and subsequently deny the Treasury additional revenues. In fact, PCIDB's are such a small portion of the capital market that Data Resources, Inc., concluded in its analysis that elimination of pollution control bonds would only provide a revenue gain of $70 million in 1983, rising to $250 million in 1985. The study's two authors could not even arrive at a definitive revenue loss to the Treasury attributable to PCIDB's.

The study found PCIDB's are a small part of the capital market that fail to impact the cost of other borrowings. As a portion of all Federal, State, and local government debt, PCIDB's account for only 1.5 percent of this debt. There is no reason to restrict PCIDB's.

Last year Congress enacted the Tax Equity and Fiscal Responsibility Act. TEFRA contained many provisions regulating IDB use. Many of these provisions are yet to be implemented. Therefore, we urge this committee not to enact further restrictions until such time when the TEFRA provisions can be analyzed as to their effect on the IDB market.

The Data Resources, Inc., and Coopers & Lybrand analysis leads to a conclusion that new restrictions are unwarranted. Congress should, however, amend the current use of PCIDB's in another manner. The council urges the committee to provide PCIDB financing for hazardous waste facilities. Currently, the Treasury Department defines solid waste as nonhazardous waste, citing the definition contained in the Solid Waste Disposal Act. However, Congress, in the Resource Conservation and Recovery Act, expanded the solid waste definition to include hazardous wastes. Congress should direct the Treasury to amend its definition of solid waste to include hazardous waste facilities as eligible for PCIDB financing.

Should further IDB restrictions be enacted, the consequences would be the need for an additional bureaucracy to regulate the use of PCIDB's and IDB's in general. In tandem with such proposals as H.R. 1635, revenue losses to the Treasury would be exacerbated as investors in PCIDB's would turn to other tax shelters and businesses would gain higher interest tax deductions.

For these reasons, the council concludes that further IDB restrictions are unwise and would only lead to a decrease of the Nation's progress to enhance the environmental quality of life.

Thank you.

This concludes my testimony. I would be happy to answer any questions.

[The prepared statement and study referred to follow:]

STATEMENT ON BEHALF OF THE COUNCIL OF POLLUTION CONTROL FINANCING AGENCIES BY RONALD BEAN, APPEARING AS PRESIDENT OF THE COUNCIL OF POLLUTION CONTROL FINANCING AGENCIES AND EXECUTIVE DIRECTOR, ILLINOIS ENVIRONMENTAL FACILITIES FINANCING AUTHORITY

MR. CHAIRMAN, MEMBERS OF THE COMMITTEE, I AM RONALD BEAN, EXECUTIVE DIRECTO OF THE ILLINOIS ENVIRONMENTAL FACILITIES FINANCING AUTHORITY. I APPEAR BEFORE THIS COMMITTEE AS PRESIDENT OF THE COUNCIL OF POLLUTION CONTROL FINANCING AGENCIES. ON BEHALF OF THE COUNCIL, I WELCOME THE OPPORTUNITY TO PROVIDE THE COMMITTEE WITH OUR VIEWS REGARDING H.R. 1635, THE INDUSTRIAL DEVELOPMENT BOND LIMITATION ACT OF 1983, AND OTHER PROPOSALS TO MODIFY THE AVAILABILITY AND USE OF TAX-EXEMPT FINANCING FOR POLLUTION CONTROL FACILITIES.

MR. CHAIRMAN, PROPOSALS TO RESTRICT THE USE AND AVAILABILITY OF IDBS FOR POLLUTION CONTROL FINANCING FAIL TO RECOGNIZE THE CRITICAL AND DISTINCT PURPOSE OF PCIDBS. H.R. 1635 WOULD DENY ACRS BENEFITS IN CONJUNCTION WITH THE USE OF A PCIDB. ACRS BENEFITS ARE SPECIFICALLY FOR THE COMPANY THAT IS MODERNIZING TO ASSURE ITS CAPITAL INVESTMENTS DO NOT ACT AS A ECONOMIC DRAG ON THE COMPANY. PCIDBS PROVIDE THE MEANS FOR A COMPANY TO EASE THE COSTS ASSOCIATED WITH THE NON-PRODUCTIVE NATURE OF POLLUTION CONTROL EXPENDITURES AND ENHANCE ITS ECONOMIC VIABILITY. POLLUTION CONTROL COSTS DO NOT ADD TO A COMPANY'S ASSETS.

POLLUTION CONTROL EXPENDITURES ARE A NON-PRODUCTIVE EXPENDITURE IN THE SENSE THAT POLLUTION CONTROL FACILITIES DO NOT INCREASE A FIRM'S PRODUCTIVITY. HOWEVER, THESE EXPENDITURES ARE MANDATED TO SERVE A PUBLIC PURPOSE, PROVIDE A CLEANER ENVIRONMENT. IT IS CRITICAL TO NOTE THESE INVESTMENTS ARE REQUIRED BY LAW. NO DISTORTION IN RESOURCE ALLOCATION OCCURS, EXCEPT AN EFFORT TO MEET A DESIRED AND MANDATED PUBLIC GOAL, CLEAN AIR, WATER AND LAND.

THE U.S. DEPARTMENT OF THE TREASURY AND PCIDB CRITICS HAVE ARGUED THAT THESE BONDS DEPRIVE THE FEDERAL TREASURY OF MUCH NEEDED REVENUES, BECAUSE OF THEIR TAX-EXEMPT NATURE. A STUDY THE COUNCIL OF POLLUTION CONTROL FINANCING AGENCIES COMMISSIONED STATED THAT ADDITIONAL TAX REVENUES WOULD NOT BE GAINED FROM FURTHER PCIDB RESTRICTIONS. THE STUDY STATED INVESTORS WHO WOULD ORDINARILY PURCHASE PCIDBS WILL SEEK OTHER TAX SHELTERS TO INVEST RESOURCES.

THUS, THE STUDY CONCLUDED, IN ORDER TO INCREASE THE TREASURY'S REVENUES, IT WOULD BE NECESSARY TO ELIMINATE ALL EXISTING TAX SHELTERS. IN ADDITION, BUSINESSES WHO DEPEND ON PCIDBS WOULD BE FORCED TO RELY ON TAXABLE CAPITAL. THIS CIRCUMSTANCE WOULD INCREASE A BUSINESS' INTEREST TAX DEDUCTION AND SUBSEQUENTLY DENY THE TREASURY'S ADDITIONAL REVENUES. IN FACT, PCIDBS ARE SUCH A SMALL PORTION OF THE CAPITAL MARKET, THAT DATA RESOURCES, INC. CONCLUDED IN ITS ANALYSIS THAT ELIMINATION OF POLLUTION CONTROL BONDS WOULD ONLY PROVIDE A REVENUE GAIN OF $70 MILLION IN 1983, RISING TO $250 MILLION IN 1985. THE STUDY'S TWO AUTHORS COULD NOT EVEN ARRIVE AT A DEFINITIVE REVENUE LOSS TO THE TREASURY ATTRIBUTABLE TO PCIDB USE.

THE STUDY FOUND PCIDBS ARE A SMALL PART OF THE CAPITAL MARKET THAT FAIL TO IMPACT THE COST OF OTHER BORROWINGS. AS A PORTION OF ALL FEDERAL, STATE AND LOCAL GOVERNMENT DEBT, PCIDBS ACCOUNT FOR ONLY 1.5% OF THIS DEBT. THERE IS NO REASON TO RESTRICT PCIDBS.

LAST YEAR CONGRESS ENACTED THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT (TEFRA). TEFRA CONTAINED MANY PROVISIONS REGULATING IDB USE. MANY OF THESE PROVISIONS ARE YET TO BE IMPLEMENTED. THEREFORE, WE URGE THIS COMMITTEE NOT TO ENACT FURTHER RESTRICTIONS UNTIL SUCH A TIME WHEN THE TEFRA PROVISIONS CAN BE ANALYZED AS TO THEIR EFFECT ON THE IDB MARKET.

THE DATA RESOURCES INC./COOPERS AND LYBRAND ANALYSIS LEADS TO A CONCLUSION THAT NEW RESTRICTIONS ARE UNWARRANTED; CONGRESS SHOULD AMEND THE CURRENT USE OF PCIDBS IN ANOTHER MANNER. CONGRESS SHOULD PROVIDE FOR THE FINANCING OF ABATEMENT AND PROCESS ORIENTED TECHNOLOGIES TO PROMOTE THE USE OF THE COST EFFICIENT POLLUTION CONTROL TECHNOLOGY THAT IS AVAILABLE. CURRENTLY, THE TAX CODE PROVIDES AN INCENTIVE TO CREATE POLLUTION RATHER THAN PREVENT POLLUTION CREATION THROUGH ABATEMENT AND PROCESS TECHNOLOGIES BECAUSE ONLY CONTROL TECHNOLOGIES ARE ELIGIBLE

FOR PCIDB FINANCINGS. BY PROVIDING FOR PCIDB FINANCING OF ABATEMENT AND PROCESS ORIENTED TECHNOLOGIES MANDATED, NON-PRODUCTIVE CONTROL COSTS CAN BE LESSENED.

SECOND, THE COUNCIL URGES THE COMMITTEE TO PROVIDE PCIDB FINANCING FOR HAZARDOUS WASTE FACILITIES. CURRENTLY, THE TREASURY DEPARTMENT DEFINES SOLID WASTE AS NON-HAZARDOUS WASTES, CITING THE DEFINITION CONTAINED IN THE SOLID WASTE DISPOSAL ACT. HOWEVER, CONGRESS, IN THE RESOURCE CONSERVATION AND RECOVERY ACT, EXPANDED THE SOLID WASTE DEFINITION TO INCLUDE HAZARDOUS WASTES. CONGRESS SHOULD DIRECT THE TREASURY TO AMEND ITS DEFINITION OF SOLID WASTE TO INCLUDE HAZARDOUS WASTE MANAGEMENT FACILITIES AS ELIGIBLE FOR PCIDB FINANCINGS. FOR THE RECORD, I AM ATTACHING MATERIAL SUPPORTING THE EXPANSION OF CURRENT AUTHORITY TO INCLUDE THE FINANCING OF HAZARDOUS WASTE FACILITIES.

THE DATA RESOURCES, INC./COOPERS AND LYBRAND STUDY AND THE ISSUES SURROUNDING THE USE AND AVAILABILITY OF POLLUTION CONTROL FINANCING INDICATE THAT FURTHER RESTRICTIONS ARE UNWISE AND WOULD NOT LEAD TO THE DESIRED END THAT PROPONENTS OF NEW RESTRICTIONS ENVISION. INSTEAD, IT WOULD LEAD TO EXACTLY OPPOSITE RESULTS.

PCIDB USE HAS BEEN MUCH OVERSTATED. PCIDBS REPRESENT A SMALL PERCENTAGE OF THE TOTAL TAX-EXEMPT BONDS SOLD. IN ADDITION, THEY ARE EVEN A SMALLER PERCENTAGE OF THE TAX-EXEMPT BONDS OUTSTANDING. THE PARTIAL SUBSIDY PROVIDED THROUGH THE TAX CODE TO BUSINESSES INSTALLING POLLUTION CONTROL TECHNOLOGIES SHOULD BE VIEWED AS A CONTRIBUTION TO, RATHER THAN A PERVERSION OF, MEETING THE DESIRED END OF A PUBLIC POLICY DECISION, PRESERVATION AND ENHANCEMENT OF THE ENVIRONMENTAL QUALITY OF LIFE.

SHOULD FURTHER IDB RESTRICTIONS BE ENACTED, THE CONSEQUENCES WOULD BE THE NEED FOR AN ADDITIONAL BUREAUCRACY TO REGULATE THE USE OF PCIDBS, AND IDBS IN GENERAL. IN TANDEM WITH PROPOSALS SUCH AS H.R. 1635, REVENUE LOSSES TO THE

Treasury would be exacerbated as investors in PCIDBs would turn to other tax shelters and businesses gain higher interest tax deductions.

For these reasons, the Council concludes that further IDB restrictions are unwise and will only lead to a decrease of the nation's progress to enhance the environmental quality of life.

Mr. Chairman, this concludes my formal testimony. I would be happy to respond to any questions the Committee may have.

EXHIBIT A

SUPPORTIVE DATA

1. Sections 103(b)(4)(E) and (F) of the Internal Revenue Code provide the only meaningful tax incentive in the Code for the acquisition of solid waste disposal or air or water pollution control facilities. Unfortunately the availability of tax exempt financing is restricted under proposed Treasury regulations which, notwithstanding EPA's objections, define pollution control facilities as only those devices that operate at the end of the production process. The rule is that any system that eliminates the creation of pollution is not for air or water pollution control. This "realized pollution" test disregards the fact that state or local governmental units and corporate citizens are designing nonproductive pollution control facilities pursuant to EPA mandate and modern technology. Further the regulations are contrary to the standards required for treating hazardous waste under RCRA.

2. The Council of Pollution Control Financing Agencies, as well as EPA, has concluded that the Service's interpretations are counter productive to the nation's environmental and energy policies. Since Treasury and the Service have ignored all requests for change, Congress must enact technical amendments to Section 103(b) that will insure tax exempt financing for companies and local government units which acquire pollution control and/or solid waste disposal facilities.

3. Since 1970, governmental units and corporations, in an effort to support the nation's environmental and energy goals have spent billions of dollars for air and water pollution control and the treatment of solid wastes. These expenses will continue into the 1980's, particularly because of the treatment of hazardous wastes required under RCRA.

4. Since the Treasury regulations do not recognize the treatment of hazardous waste as being for the control of air or water pollution or solid waste, such expenditures are denied, arbitrarily, the benefits of tax exempt financing. Further, since all potential polluters are adopting technology for eliminating pollution rather than designing facilities that operate on pollutants at the end of a pipe, they are precluded from fully utilizing Section 103(b)(4)(F). This denial is unfair -- the tax incentive already exists -- and adds to the costly burden of acquiring nonproductive assets.

5. The proposed regulations penalize governmental units and corporations for being good citizens.

6. Congress should enact technical amendments to Sections 103(b)(4)(E) and (F) to guarantee that those who comply with the nation's environmental and energy standards will obtain the existing statutory tax incentives.

Introduction

The Council of Pollution Control Financing Agencies is a Section 501(c)(3) organization devoted toward the education of the public through an annual symposium, workshop programs and publications of the nation's environmental standards including analyses of regulatory actions. Its voting members are state or local government agencies charged with aiding either state or local government units or companies in financing their environmental compliance programs. Attached hereto as Exhibit A is a more complete description of the Council.

Its non-voting members consist of public members such as investment bankers, law firms and companies. This broad based membership has allowed the Council to establish a liaison with officials with policy responsibilities affecting pollution control financing at the Environmental Protection Agency, Council on Environmental Quality, Treasury Department, Securities and Exchange Commission, and Small Business Administration.

The combination of Council policy and membership affords the Council a unique position within our system. It is from this broad base of experience that the Council has learned of a serious problem relating to pollution control financing caused by the Internal Revenue Service and proposed Treasury Regulations. Further, the Council believes the harmful effects of the regulations will be exacerbated by reason of the need for compliance under RCRA. Accordingly, the Council appears before this Committee to suggest that it act immediately to clarify Sections 103(b)(4)(E) and (F) as discussed below. Since the Service and Treasury have ignored both EPA and the Council's comments that the regulations are contrary to Congressional intent, inconsistent with national environmental and energy policies and detrimental to both state and local governmental agencies charged with financing environmental protection systems and companies efforts to finance nonproductive facilities, Congress must intervene.

Present Law

Industrial development bonds, *i.e.*, bonds defined in Section 103(b) of the Code as being issued by or on behalf of states or their political subdivisions for the benefit of private businesses, generally do not bear tax exempt interest under Section 103(a). However, where the proceeds of the bonds will be used for certain "exempt activities" (*e.g.*, air or water pollution control facilities, solid waste disposal facilities, etc.) the bonds will bear tax exempt interest.

Realized Pollution Test

The Treasury and the Internal Revenue Service have promulgated and proposed various definitions of the types of facilities that may be regarded as being pollution control and solid waste disposal facilities. Many of these rules so narrowly restrict the types of facilities qualifying for tax exempt bond financing that they are contrary to the underlying statute and to some of the policies of the EPA.

In particular, Proposed Reg.§§1.103-8(g)(2)(ii), (iii) and (iv) adopt a "realized pollution" test. This test holds that facilities which prevent pollution are not for the control of pollution. Thus only "end of pipe devices" qualify for tax exempt financing. Excluded by the regulatory definition of air or water pollution control are such facilities, even if acquired pursuant to EPA mandate under the Clean Air Act, the Federal Water Pollution Control Act, or RCRA, that treat hazardous waste, eliminate the creation of a pollutant through process changes, control a "nuisance", or are used "traditionally or customarily" by an industry. This interpretation belies Congressional intent and is at odds with the modern methods of pollution control which are being developed by industry in cooperation with the EPA.

The law permitting tax exempt financing of pollution control and solid waste disposal facilities was enacted in 1968 to encourage the installation of such facilities. Such equipment is frequently placed in service because public policy demands that the environment be protected even though this may require investment that either is unprofitable for a producer or involves a high degree of financial risk. The Service's failure to give proper recognition to these facts is philosophically unfair and statutorily improper.

Gross Savings Test

Assuming the facility meets the so-called "realized pollution test", the position of the Internal Revenue Service is that the allowable amount of financing for a pollution control facility is its cost reduced by the value of any recovered useful by-product, or the value of any form of "gross" economic benefit to the manufacturer.

Proposed Reg §1.103-8(g)(3) guarantees a reduction in allowable financing even where off-setting costs of operation associated with a pollution control device equal or exceed the alleged benefits. This formula is inconsistent with EPA guidelines, contrary to standard accounting methods, and legally arbitrary.

Hazardous Waste

As stated earlier, facilities which treat hazardous wastes fail to meet the realized pollution test and accordingly do not qualify as an air or waste pollution control facility under Section 103(b)(4)(F). Even if such devices are acquired pursuant to the Solid Waste Disposal Act, the Treasury regulations deny tax exempt financing under Section 103(b)(4)(E).

In the case of the exemption for solid waste disposal facilities, the term "solid waste" has been defined by the Internal Revenue Service to mean solid waste within the meaning of the Solid Waste Disposal Act as it existed in 1968, despite the fact that the Act has been amended to modernize the government's response to the problem of solid waste disposal. Thus, for example, solid waste disposal facilities as defined and mandated by Congress in RCRA are excluded from qualifying for tax-exempt financing.

Congress Must Act

Proposed Bill or Amendment

The Committee should pass a bill or an amendment, the purpose of which would be to clarify the meaning of the terms "solid waste" and "pollution control" for purposes of Sections 103(b)(4)(E) and (F). It should be clear that the Committee believes that the Treasury and Internal Revenue Service's interpretations are too restrictive and that a reasonable definition of those terms was intended by the Congress when it originally enacted Section 103(b)(4). Further, the Committee should make it clear that artificially narrow definitions do not promote the legislative purpose of the provision, i.e., to encourage pollution control and solid waste disposal.

The definition of pollution control facilities should include any facility that is installed, in whole or in part, for the purpose of abating, controlling or preventing water or atmospheric pollution so long as a certification to that effect is given by a responsible local, state or Federal environmental agency. The effect of such a provision would be to ensure that environmental agencies have the authority to determine whether or not tax incentives are consistent with overall environmental policy. Thus, statutorily, the prevention of pollution is the same as the control of pollution.

In order to guarantee that only the portion of the cost of pollution control facilities which are not recouped by net economic benefits is eligible for financing, the bill could provide for a reduction in costs eligible for financing to the extent of net economic benefits. No such reduction should be made, however, where the facility is installed primarily for pollution control. Thus, the bill should provide a conclusive presumption that the entire cost of a facility qualifies for tax-exempt financing if the facility would not have been installed but for pollution control purposes.

In the case of solid waste disposal facilities, the bill should contain the provisions of present law which recognize and encourage economic solid waste disposal, including resource recovery and profit-making recycling. However, the bill clarifying the definition of solid waste can be accomplished so that it is the same definition of "solid waste" that is contained in The Solid Waste Disposal Act as amended. This provision will negate the unrealistic idea that the definition of solid waste under Section 103 of the Code is to remain frozen to 1968. Solid waste disposal facilities under Section 103 reflect changing environmental policy. Thus, for example, the bill should include hazardous waste within the definition of solid waste.

Conclusion

The Council of Pollution Control Financing Agencies, as well as many taxpayers, and the EPA have advised the Treasury and Internal Revenue Service that its regulations are legally arbitrary and inconsistent with the Nation's environmental and energy goals. Since these comments have not been repudiated *i.e.*, they have been totally ignored, Congress must amend Sections 103(b)(4)(E) & (F) to guarantee that environmental judgments can be made by those entities capable of ascertaining most intelligent environmental policy without prejudicing governmental units or companies tax rights.

EXHIBIT B

COUNCIL OF POLLUTION CONTROL FINANCING AGENCIES

The Council is a national non-profit organization of state and local public agencies which issue pollution control revenue bonds and provide economic assistance to industry for financing pollution abatement facilities. It was formed in 1978, with the following objectives:

- To encourage and facilitate capital financing for environmental improvement and energy conservation.
- To support and further the interests of local and state agencies in assisting industry in achieving environmental quality goals.
- To aid and assist in the development of financial and economic incentives for environmental improvement.
- To support research and provide information about the needs, purposes and benefits of pollution control financing.
- To promote better coordination of federal, state and local policies and regulations for the compatibility of environmental improvement, efficient energy use and economic growth.

The Council provides technical assistance for its members' services for their communities. Among these are meetings and publications, sponsoring consultation among members, and program evaluation and recommendations. Council functions are designed to inform and educate the business, governmental and financial communities about the issues, developments and opportunities for more economical and equitable means of financing environmental improvement.

The Council's members are comprised solely of state and local units of government and their officials, and its Associates include banking, law, engineering and industrial firms.

DRI Data Resources, Inc.

AN ANALYSIS OF TAX-EXEMPT POLLUTION CONTROL FINANCING

FINAL REPORT

Prepared for

THE COUNCIL OF
POLLUTION CONTROL FINANCING AGENCIES

DATA RESOURCES, INC.
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June 1983

EXECUTIVE SUMMARY

Pollution Control Industrial Development Bonds (PCIDBs) are tax-exempt revenue bonds issued by states, state agencies, counties, cities and regional authorities for use in financing industrial pollution control facilities. They are secured by corporate payments on leases, installment sales, loans or guarantees. The volume sold has grown from less than $100 million in 1971 to $6.1 billion in 1982, prompted by such legislation as the Clean Air Act of 1970, the Water Pollution Control Act of 1972, and the Power Plant and Industrial Fuel Use Act of 1978.

PCIDBs are used to finance a significant proportion of all expenditures for pollution control plant and equipment. Over the past 10 years, sales of PCIDBs have equaled an average of 32 percent of all pollution control expenditures, ranging from 15 percent in 1972 to 44 percent in 1981 (Table 1). The major users are electric utilities, which accounted for 70.2 percent of all PCIDBs sold in 1981, oil and chemical companies, metal processors and paper companies. Electric utilities increased their investment in pollution control equipment as they began converting to coal-fired plants in the aftermath of the 1970s energy crisis and in compliance with federal law. This segment of the PCIDB user population will diminish in importance, however, as existing plants complete the conversion process, and in view of the 1982 legislation limiting the tax-exempt feature to conversions of plants that were in existence at the end of 1982. This legislation will force industry to choose between tax-exempt financing for construction of pollution control facilities at new plants or the tax benefits of accelerated depreciation.

PCIDBs are one form of Industrial Development Bonds (IDB), which recently have been the object of concern to the Treasury Department, because of the theoretical tax loss resulting from the federal income tax exemption of IDB interest. Other criticism has come from municipal officials who contend that the presence of IDBs in the bond market tends to drive up interest rates on municipal bonds. PCIDBs, which account for less than 15 percent of all IDBs sold, are included in the general criticism of IDBs.

This report is an analysis of the effects of Pollution Control Industrial Development Bonds (PCIDBs) on the economy. Its major conclusions are the following:

- PCIDBs represent a small portion of the outstanding debt in the economy. The volume of PCIDBs outstanding is less than 5.6% of all tax-exempt debt and less than 0.5% of the total privately held capital (Table 4).

- The impact of this volume of PCIDBs on the overall capital market is minor.

- PCIDBs are an important source of financing for pollution control facilities that are required by federal law and were authorized to ease the burden of capital expenditures by industry. These expenditures are not discretionary and probably would be financed by non-tax-exempt sources of capital if PCIDBs were not available. The effects of eliminating PCIDBs would vary by industry. For those who receive PCIDB financing, borrowing costs would be higher per dollar by the difference between the taxable and tax-exempt financing rate.

- Coopers & Lybrand and Data Resources independently analyzed the impact of PCIDBs on the capital markets using substantially differing methodologies. The approaches of the two firms are theoretically disparate, yet the empirical results are similar:

  * Coopers & Lybrand concludes that the impact on interest rates in the municipal bond market would be nearly the same regardless of how these legally-mandated pollution control facilities were financed. This is due to the efficiency of the capital market, its scale and the widespread effects of arbitrage. This adjustment to the increase in capital costs associated with the issuance of PCIDBs permeates the financial markets in a relatively short period of time.

  ** Data Resources' work indicates that the impact of PCIDBs on the municipal bond market is smaller than previous studies have suggested. Specifically, Data Resources concludes that a $1 billion increase in tax-exempt borrowing would raise tax-exempt interest rates by about two basis points relative to comparable taxable rates. This is because the marginal buyer of tax-exempt bonds is indifferent between purchasing tax-exempt and taxable bonds of the same term and quality; for the marginal buyer, the after-tax returns are equal. As the volume of tax-exempts increases, investors in lower tax brackets must be drawn into the market, thereby reducing the marginal tax rate that equilibrates the market. As a result, tax-exempt rates will rise relative to taxable rates, so the spread between tax-exempt and taxable rates will decrease.

- o The supply of tax-exempts is interest-inelastic, as a one basis point rise in tax-exempt rates would reduce tax-exempt borrowing by $10 million, or 0.02% of total state and local bonds and notes issued in 1982 (Table 4).

- o Coopers & Lybrand's and Data Resources' independent estimates of the federal revenue losses from PCIDBs differ due to varying assumptions underlying the estimates:

  - * Coopers & Lybrand's assumptions lead to an estimate of a tax revenue loss to the Treasury no higher than $475 million in 1981 and $545 million in 1982.

  - ** Under Data Resources' assumptions, the gross federal revenue losses from PCIDBs range from $700 million to $1 billion in 1982. Elimination of all PCIDBs issued after 1982 would raise revenues by $80 million in 1983, rising to $370 million in 1985. Assuming a liberal amount of economic feedback from the lost investment stimulus, the revenue gain would be $70 million in 1983, rising to only $250 million in 1985.

- o A myriad of tax shelters is available to investors at different levels of risk and return. It is likely that most investors would find other means of sheltering their income if tax-exempt PCIDBs were not available. To the extent investments in PCIDBs were replaced by investments in other tax-exempts or tax shelters, the loss to the Treasury would remain the same.

INTRODUCTION

This report discusses the development and use of pollution control industrial development bonds (PCIDBs) and their effects on the U.S. economy relative to other forms of long-term debt. The second section provides a description of pollution control financing as a specialized form of industrial development bond used to finance construction of pollution control facilities required under federal environmental regulations. The third section describes the impact of PCIDBs as tax-exempt investments.

The lack of adequate publicly available information on individual PCIDB issues has required use of some simplifying assumptions in this report. These are listed below.

- Since there has been no requirement that PCIDBs be registered with the federal government or with many state governments, the volume of PCIDBs used in our analysis consists of those reported to organizations such as the Public Securities Association, The Bond Buyer and Moody's Bond Report. This significantly understates the total volume of PCIDBs, as many fall in the category of small issues and are privately placed in local banks. Other issues have been reported to one of the organizations listed above, but not to the others. Thus, reports of PCIDB sales vary, even among the organizations that compile this information regularly. Accurate figures for the sales of small issue IDBs are not available, and the best estimates, prepared by the Congressional Budget Office in 1982, do not distinguish between small issue PCIDBs and others. Estimates of the value of small issue IDBs have been given for a few individual years, but there is not consistency in these estimates, so only reported PCIDB issues have been used. Information published in the Daily bond Buyer has been the major source of PCIDB data.

- There is no compiled information showing PCIDB volume outstanding. Therefore, data shown in this report are generally for new issues of IDBs. Since the first PCIDBs were issued in 1971, and because until the past few years most PCIDBs were long-term issues, the number of PCIDBs maturing since 1971 is assumed to be no higher than 5 percent. Therefore, where a value is given for PCIDBs outstanding, it has been calculated using this assumption.

- It was assumed that purchasers of PCIDBs are similar in composition to the purchasers of municipal bonds, and that the majority of PCIDBs are currently purchased by households or Municipal Bond Funds, the fastest growing segments of the population of municipal bond holders. No statistics were available regarding, specifically, the purchasers of PCIDBs.

INDUSTRIAL DEVELOPMENT BONDS: A BRIEF OVERVIEW

Tax-exempt securities have been the traditional mechanism of state and local governments to finance public improvements such as schools and roads. In recent years, another category of tax-exempt securities, generally referred to as industrial development bonds (IDBs) has become important. IDBs are tax-exempt bonds whose proceeds are used by individuals and organizations which are not tax-exempt and the obligation is secured by the property and receipts of the project rather than the full faith and credit of the issuer. The first condition requires that the proceeds are used by a taxable entity and is called the "trade or business test," while the second condition requires that the obligation is secured by the project's receipts and is called the "security interest test." The bonds are sold by states, state agencies, counties and cities, and the proceeds of the bond sales are generally either loaned to private firms, or used to acquire facilities which are then leased to private firms. Although some IDBs have been general obligation bonds backed by the issuers' taxing power, virtually all IDBs are now revenue bonds, secured by the property or receipts of the project financed. IDBs are thus priced by the market primarily on the basis of the credit worthiness of the private participant rather than the public user. Thus, the governmental unit serves as a financial intermediary, offering the firm lower borrowing costs because of the tax-exempt feature of IDBs.

The use of tax-exempt credit for private purposes originated in 1936 in Mississippi. Such issues remained small and localized in the South through the 1950s. In the early 1960s, IDB issuance rose substantially. More issuers adopted the revenue version of IDBs. The enactment of the Revenue and Expenditure Control Act of 1968 denied tax-exempt status to IDBs except those designated as "small issues" or those that finance certain types of facilities. The small issue exemption limits the issue to less than $10 million. Certain facilities are exempt from the small issue restrictions. These facilities are low income residential property; sports facilities; convention facilities; transportation facilities; sewerage, water, solid waste and energy facilities; qualified mass transit vehicles; and air and water pollution control facilities.

The use of IDBs accelerated in the 1970s when large numbers of smaller issues were sold. By 1979, IDBs reached $9.8 billion or 32.9% of total tax-exempt obligations. This continuing growth of tax-exempt financing for private purposes led Congress to curb financing of housing by IDBs. Provisions of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) place several additional restrictions on IDBs. These restrictions include sunsetting of the small issue exemption after 1986, a limitation of straight-line depreciation over ACRS asset lifetimes (not applicable to pollution control facilities installed in existing plants), and established reporting requirements which will go into affect July 1, 1983.

Pollution Control IDBs (PCIDBs) are revenue bonds secured by corporate payments on leases, installment sales, loans, or guarantees as are most IDBs. Pollution control exemption regulations are complex and place heavy emphasis on the relationship of the pollution control improvement to the overall industrial process. Users must show that the improvement to be financed by PCIDBs is for the control of pollution and is not designed to meet any significant purpose but pollution control. The PCIDBs receive ratings based primarily upon the type of security feature and the credit worthiness of the user of the pollution control facilities.

- o PCIDBs were first issued in 1971. In that year, $0.1 billion were sold through 10 issues. PCIDB sales have increased since to a high of $6.1 billion sold through more than 150 issues in 1982. The PCIDB offers several advantages to the borrower. The first is reduced interest costs due to the tax-exempt feature of the bond. Generally, tax-exempt securities earn yields that are roughly 70% of those of comparable taxable securities. This implied a differential of nearly 400 basis points in 1981, which translates into a gross savings of roughly $8 million in interest costs on a $10 million issue with a 20-year maturity. Second, SEC registration costs and related legal expenses may be avoided, since the bonds need not be registered. However, PCIDBs involve additional costs not found in taxable financing such as municipal bond councels' fees, other municipal fees, and higher underwriters' fees than usually found in the tax-exempt market. Third, in some cases, the borrower may be exempt from various state and local taxes. Fourth, through leasing arrangements that can become rather complex, the borrower can achieve additional savings, through accelerated depreciation, and investment tax credits, or by leasing through third parties.

The impact of PCIDBs on various segments of the economy is described in the following section.

THE ECONOMIC IMPACT OF PCIDBs

The volume of PCIDBs is quite small relative to other debt instruments in the economy. However, they account for a substantial amount of the financing for the pollution control facilities that are required under federal environmental regulations. Although their impact on the overall economy is slight, they are an important source of financing for industries that are required to make a large investment in pollution control facilities. This report identifies the issuers and purchasers of PCIDBs, and analyzes the impact of PCIDBs on the capital markets and on the Treasury.

The data used in this analysis were compiled from published information in The Daily Bond Buyer and other trade publications as well as reports prepared by the U.S. Treasury Office of Tax Analysis, the Congressional Budget Office and the Federal Reserve.

Issuers and Purchasers of PCIDBs

Industry Use of PCIDBs

The major impetus for PCIDBs was the passage of Federal environmental legislation, namely the National Environmental Protection Act of 1969, the Clean Air Act of 1970, and the Water Pollution Control Act of 1972. Other legislation, particularly the Power Plant and Industrial Fuel Use Act of 1978, the Resource Conservation and Recovery Act, the Safe Drinking Water Act and the Superfund legislation have also provided important incentives to the growth in PCIDB sales. These laws require large-scale investment by industry to meet the legislated environmental standards. As shown in Table 1, pollution control plant and equipment expenditures (PABE) rose from $3.9 billion in 1972 to $9.2 billion in 1980 before declining to $8.9 billion in 1981. The percent of PABE financed by PCIDBs has averaged about 32%, ranging from 15% in 1972 to 44% in 1981. The future growth of PCIDBs depends on the volume of PABE needed to satsify pollution control standards and the ability of state and local governmental units to sponsor tax-exempt financing, which depends on individual IRS rulings and changes in tax and environmental legislation.

Table 1

PCIDB's as a Percent of
Pollution Control Plant and Equipment Expenditures
($ Billions)

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981
Pollution Control Plant & Equipment(1)	3.9	4.9	5.7	7.0	7.2	7.3	7.6	8.4	9.2	8.9
PCIDB's(2)	.57	1.8	1.7	2.1	2.1	3.0	2.8	2.5	2.5	3.9
Percent	15%	37%	30%	30%	29%	41%	37%	30%	27%	44%

Source: (1)U.S. Department of Commerce, Bureau of Economic Analysis
(2)The Daily Bond Buyer

Of particular importance is a TEFRA provision that restricts the use of ACRS depreciation for air and water pollution control facilities financed by tax-exempt bonds to those built for use in connection with plants or other property in operation, under construction or financed before July 1, 1982. This limitation, in effect, will force industry to choose between tax-exempt financing for pollution control equipment on new plants using a straight-line depreciation write-off, or using taxable financing and a faster write-off of depreciation. No longer will both tax-saving provisions be available for new construction.

The major users of PCIDBs have been electric utilities and oil and chemical companies. Other significant users are paper companies, manufacturers and metal processors. Electric utilities have consistently been the chief industrial beneficiaries of PCIDB financing, accounting for more than 65% of PCIDB sales in 1977 and more than 70% in 1981. Much of this financing was required in the wake of the 1970s' energy crisis as existing power plants switched from oil and gas boilers to coal-fired generators, which require extensive pollution control installations, and new power plants were built to use coal. The dollar value of PCIDBs issued for electric utilities ranged from $60 million in 1973 to $2.2 billion in 1977 and $2.75 billion in 1981. Preliminary reports based on the first three quarters of 1982 indicate that the utilities' proportion of PCIDBs sold was still the highest of any industry, with an annual dollar value more than $3 billion. The value of PCIDBs used for utilities' conversion to coal can be expected to decline as most of the conversions prompted by the 1970's energy crisis are completed.

The other major users of PCIDBs listed in Table 2 are expanding their pollution abatement expenditures for both air and water pollution control, and most facilities so financed are being constructed to meet extended compliance deadlines of the Clean Air Act and the Water Pollution Control Act. Under the Water Pollution Control Act, industrial point sources of pollution were required to adopt "the best practicable control technology currently available" by 1977 and the "best available control technology achievable" by 1984 in order to meet federal effluent standards. Provisions of the Clean Air Act specify design criteria for certain industries and require industry to operate within certain stationary source air pollution standards. In addition, under the Clean Air Act, construction of new facilities emitting high levels of pollutants has been restricted until national ambient air standards are met.

Table 2

Distribution of PCIDB Users by Industry
(Percent)

Year	73	74	75	76	77	78	79	80	81
Percent of PCIDB's By Industry									
Electric Utilities	33	56.3	29.3		65.3			58	70.2
Metal Processing	22	10.7	24.7						
Oil Companies	5	11.7	10.3					4.8	11.2
Manufacturing									5.2
Chemical	11	4.7	11.8						4.5
Forest Products (Paper)	11	9	10.4						3.0
Total given percent	82	92.4	86.5		65.3			62.8	94.1

Source: The Bond Buyer

The effects of the elimination of PCIDBs would vary significantly by industry. With PCIDBs, certain firms and certain investments receive lower interest costs from tax-exempt financing. Their borrowing costs are lower per dollar by the difference between the taxable and tax-exempt financing rate.

PCIDB Purchasers

The purchaser of PCIDBs is assumed to have similar investment needs and strategies as the purchaser of other municipal bonds. As shown in Table 3, commercial banks, households, property liability companies and municipal bond funds are the largest participants in the municipal bond market. Households and municipal bond funds have been the fastest growing segments since 1975. It can be assumed that the composition of PCIDB holders is similar to that of the municipal bond market in general.

Table 3

Holders of Municipal Bonds

Holder	($Billions) Outstanding 12/31/82	Cumulative Change (1975-1982)	Projected Net Change 1983
Domestic Commercial Banks	157.0	+55.1	+5.8
Households	138.5	+67.4	+35.0
Property Liability Cos.	86.4	+53.1	+2.4
Municipal Bond Funds	48.7	+42.6	+15.8
Life Insurance Cos.	8.2	+2.9	+.9
State & Local Retirement Funds	4.0	+2.1	-.1
Nonfinancial Bus. Corps.	3.6	-1.0	-2.5
Mutual Savings Banks	2.2	+.7	0
Security Brokers & Dealers	1.4	+.9	+.7
Savings & Loans	1.1	-.4	-.1
Total	451.1	+223.4	+57.9

Source: Salomon Brothers, 1983 Prospects for Financial Markets

It is likely that most purchasers of PCIDBs are individuals, either buying for their own account or through investments in municipal bond funds. As long as interest rates remain high relative to the return on other investments, all bonds will be attractive investments. The higher an individual's tax bracket,the more attractive tax-exempts will be. As the yield on tax-exempts increases relative to the taxable rate, the attractiveness of all tax-exempts increases for individuals with marginal tax rates equal to one minus the ratio of the tax-exempt rate to the taxable rate. Thus, as the tax-exempt rate has generally been about 70 percent of the taxable rate, tax-exempt bonds are most attractive to individuals with marginal tax rates higher than 30 percent. Individuals in the 30 percent tax bracket are indifferent between tax-exempts and taxables, as their return would be the same from either investment. Individuals with marginal tax rates of less than 30 percent would prefer taxable investments, as long as the tax-exempt rate remains no higher than 70 percent of the taxable rate. As the supply of tax-exempts increases relative to taxables, however, the relative tax-exempt rate rises to attract investors in the lower brackets.

PCIDB Impact on Capital Markets and the Treasury

Economic and Market Forces

The criticism of IDBs is based on the economic argument that IDBs provide preferential treatment for certain firms or industries in the form of lower interest costs for tax-exempt financing. In the case of pollution control financing, however, it is important to recognize the real economic versus the financial forces that are at play. The real economic decision to allocate productive resources to pollution control activities is mandated by a public policy decision. There is a fixed amount of this activity that will occur under a given interpretation of that policy. Once these resources are committed, the major economic reallocation is completed. The installation of pollution control facilities mandated by federal law does not increase a firm's productive capacity, and thus would not be economically attractive to a company which could expect no financial return on its investment. There would be no economic incentive, therefore, for a rational company to divert any of its resources to pollution control. It follows, then, that the implicit government subsidy through PCIDBs is not likely to divert any more capital than is necessary to meet federal standards, and that this diversion is due to the policies requiring installation of the equipment, not the availability of a particular form of financing.

The main issue then becomes the relative and absolute effects which occur in the financial markets, in connection with the financing of these investments. The provision of tax-exempt financing has the effect of distributing a portion of the cost of pollution abatement over all taxpayers, rather than recovering it solely from the purchasers of the products of the polluting firms. Simply put, the elimination of PCIDBs may prompt the affected industries to raise their prices for electricity, steel, paper, chemicals and other products using these materials, to recover the higher interest costs of non-tax-exempt debt. Public policy has determined that these industries and their customers should not bear the entire burden of meeting stiffer environmental standards.

Impact on the Bond Market

Coopers & Lybrand and Data Resources independently analyzed the impact of PCIDBs on the financial markets. Despite the use of two dissimilar methodologies, the empirical results are remarkably similar. This section discusses the two firms' analyses of the implications for the financial markets.

The Coopers & Lybrand evaluation looks at the aggregate impact of PCIDBs on the bond market and then asks whether there are any theoretical/empirical reasons to believe that a particular market segment would be differntially affected by PCIDBs. This analysis concludes that in the aggregate, the impact on the overall cost of capital would be very small. Yes, the presence of PCIDBs in the municipal bond market does have an effect on all capital costs. However, this effect is felt by all participants in the financial markets, and the specific impact on the tax-exempt market is small. Coopers & Lybrand recognizes that the financial markets do not instantanously adjust to these market equilibrating forces, and believes that given the magnitude and efficiency of the capital markets in the U.S., the effects of arbitrage work very rapidly and that the "short-run" is not of sufficient duration for these interim adjustment positions to be of concern. There are three important reasons for this conclusion:

- Small PCIDB Volume. Over the past 10 years, PCIDBs have averaged approximately 10 percent of total new tax-exempts issued. By the end of calendar year 1982, PCIDBs comprised less than 6 percent of outstanding tax-exempt notes and bonds, 1.5 percent of all outstanding privately held federal, state and local government debt, and less than 1.5 percent of long-term corporate debt. (See Table 4). At that time, the value of PCIDBs outstanding was approximately $26 billion. This is less than 0.5 percent of all privately held capital in the economy. The minimal incremental demand for capital attributable to PCIDBs does not significantly affect this vast market.

- Market Forces. Before the existence of PCIDBs, a vast array of forces was at work in the capital market. These forces incorporated differentials in the rates of return, risk, maturities and tax effects of all financial instruments. The presence of a small volume of PCIDBs has little material impact on these differentials. What impact there is spread over all markets and, as a result, is virtually negligible.

- Effects of Arbitrage. The impact of PCIDBs will be felt in all markets. Assuming the existence of an efficient capital market, that information is free and readily available to all and that investors behave rationally, any increase in the demand for capital in any part of the capital market will be spread over all segments through the actions of arbitragers. Therefore, while an increase in the demand for tax-exempt financing will initially have the effect of raising the yield on tax-exempts, such a tendancy will raise the return to tax-exempts relative to other instruments, making the latter less attractive. Investors will shift quickly from less to more attractive instruments until they ultimately raise the return on all market instruments.

Thus, the incremental demand for capital to finance legislatively-mandated pollution control facilities will have the effect of raising interest rates on municipal bonds. However, the effect would be nearly the same if the same amount of capital were raised through taxable debt. At market equilibrium, the only difference between interest rates for taxable and tax-exempt debt will be the tax effect for investors.

Table 4

PCIDBs as a Percent of Other Debt Instruments
($ Billions)

	1976	1977	1978	1979	1980	1981	1982	Outstanding 12/31/82
State and Local Bonds and Notes (Net of Refundings, Maturities and Sinking Fund Purchases)	17.6	28.9	32.5	27.9	33.0	32.2	51.9	451.1
PCIDBs	2.1	3.0	2.8	2.5	2.5	3.9	6.1	25 (est)
Total Government Debt	90.9	104.4	115.1	105.3	151.5	155.2	267.7	1,682.1
Long Term Corporate Debt	109.4	144.3	150.4	148.5	121.5	103.7	57.8	1,857.9
Total Demand for Credit	255.1	348.8	408.2	397.3	349.4	408.7	399.4	4,889.7
			- Percent -					
PCIDBs as a Percent of State and Local Bonds and Notes	11.9	10.3	8.6	8.9	7.6	12.1	11.8	5.6
Total Government Debt	2.3	2.9	2.4	2.4	1.7	2.5	2.3	1.5
Long Term Corporate Debt	1.9	2.1	1.9	1.7	2.1	3.8	10.6	1.4
Total Demand for Credit	0.8	0.9	0.7	0.6	0.7	1.0	1.5	0.5

Source: Salomon Brothers, 1983 Prospects for Financial Markets
The Bond Buyer (PCIDB volume)

Table 5

PCIDB Interest Rates Compared to
Municipal and Corporate Utility Bonds
(Percent)

	1973	1974	1975	1976	1977	1978	1979	1980	1981
PCIDBs/AA/25-30 Year(1)	5.68	6.98	7.44	6.31	5.81	6.37	6.81	8.86	10.71
GO Bonds/A/20 Year (2)	5.22	6.25	7.10	6.56	5.67	6.04	6.52	8.58	11.33
Corporate Utility/AA/29 Year(1)	7.83	9.41	9.45	8.67	8.33	9.09	10.24	13.14	16.25

Source: (1) Moody's Bond Report
(2) The Bond Buyer

Data Resources constructed a model of the tax-exempt bond market in order to estimate the effects of PCIDBs on tax-exempt interest rates and the volume of tax-exempt borrowing for traditional purposes. Over time, tax-exempt interest rates move sympathetically with taxable rates, since both tax-exempt and taxable rates are influenced by the same financial conditions. Tax-exempt rates are lower because of the advantage of tax-exemption to the holder. The spread between the tax-exempt rate and the taxable rate will equal one minus the marginal tax rate of the marginal buyer of tax-exempt issues:

$$r_e = (1-t_b^*)\, r_t$$

where

r_e - tax-exempt rate

r_t - taxable rate

t_b^* - the marginal tax rate of the buyer who switches from taxable to tax-exempt issues

This marginal buyer is indifferent between purchasing tax-exempt and taxable bonds of the same term and quality; for the marginal buyer, the after-tax returns are equal. Individuals with marginal tax rates above t_b^* will prefer to hold only tax-exempts, while individuals with marginal tax rates below t_b^* will prefer to hold taxables. The value of t_b^* that equilabrates tax-exempt yields depends upon the relative quantities of taxables and tax-exempts placed in the market. Most purchases of tax-exempts are by households, bond funds, commercial banks, and fire and casualty insurance companies. For example, these three sectors held 89% of the net new issues in 1981. Commercial banks purchase tax-exempts once they have met their commitments to other borrowers, if they have taxable income to shelter. The demand of fire and casualty companies is highly unstable, depending on their cash flow needs. As a result, the household sector can be considered the residual absorber of tax-exempts. Tax-exempt interest rates will adjust relative to the taxable interest rate to attract enough buyers from the household sector to clear the market.

As the volume of tax-exempts increases, more household investors in lower tax brackets must be drawn into the market, thereby reducing the marginal tax rate, t_b^* that equilibrates the market. As a result, tax-exempt rates will rise relative to taxable rates, causing the spread between tax-exempt and taxable rates to decrease. On the other hand, if the supply of tax-exempts declines, the equilibrating value of t_b^* will rise as fewer tax-exempts are purchased by households. As a result, tax-exempt rates will fall relative to taxables, and the spread will widen.

A fully specified model of the municipal bond market would include nine equations: (1) a supply equation for state and local government bonds; (2) a supply equation for PCIDBs; (3) a supply equation for all other IDBs; (4) a demand equation for the purchases of fire and casualty insurance companies; (5) a demand equation for the purchases of commercial banks; (6) a demand equation for the purchases of all other institutions; (7) a market clearing interest rate equation for tax-exempts; (8) an interest rate equation for PCIDBs, and (9) an interest rate equation for all other IDBs. The last two equations capture the interest rate premia on IDBs from their segmentation from the rest of the tax-exempt market. Appendix A reviews earlier models of the tax-exempt market and describes the estimation and simulation of the DRI tax-exempt bond market model.

The empirical results derived from the municipal market model constructed by DRI indicate that a $1 billion increase in state and local borrowing, whether it is PCIDBs, IDBs, or general obligation bonds, raises state and local borrowing rates by about two basis points relative to comparable taxable rates. This result is only about one basis point higher than the findings of Kormendi and Nagle (1981), but is much lower than the increase of four to seven basis points reported in Petersen (1979).

The modelling results also suggest that the sensitivity of the supply of state and local obligations is relatively interest-inelastic with respect to variations in state and local borrowing rates. A one basis point increase in state and local borrowing would lower state and local borrowing by at most $10 million.

Impact on the Treasury

The Treasury Department has estimated that the tax revenue loss attributable to PCIDBs was $720 million in 1981 and $825 million in 1982. As stated in the 1984 Budget Special Analyses, these estimates "are not equivalent to estimates of the increase in Federal receipts that would accompany the repeal of tax subsidy provisions." Thus, these estimates actually overstate the impact of PCIDBs on the Federal tax receipts, since there are offsetting revenues associated with PCIDBs as well as "tax expenditures."

Coopers & Lybrand and Data Resources independently estimated the federal revenue losses from PCIDBs. Varying assumptions underlie the estimates. Therefore, the two approaches result in different estimates of the tax revenue loss to the Treasury.

Coopers & Lybrand's estimate of the actual loss in Federal receipts takes into consideration the offsetting factors associated with PCIDBs. The most important is the increase in tax revenues due to reduced tax deductions for firms using lower-interest PCIDBs rather than taxable debt to finance pollution control facilities. In view of the legal requirements that firms install these facilities, it can be assumed that firms would use taxable debt to finance the required modifications if PCIDBs were not available. The costs to industry of using taxable debt would be reduced by the increase in interest tax deductions, which would reduce the taxes paid by a percentage equivalent to the PCIDBs-user firms' effective tax rate.

Since no composite estimates are available of the overall tax rate for all bond issuers, Coopers & Lybrand used the average tax rate for electric utilities—the major industry using PCIDB financing—to estimate the offsetting gains in tax revenues attributable to this factor. The average tax rate for electric utilities has been approximately 34 percent in recent years. Applying this percentage to the Treasury's revenue loss estimates would reduce those estimates to approximately $475 million in 1981 and $545 million in 1982. These revised estimates should constitute an upper bound on the tax revenue loss attributable to the tax-exemptions for PCIDB interest.

Data Resources' estimates of the federal revenue losses from PCIDBs are developed from a multi-asset model developed by Harvey Galper and Eric Toder. In this model, the only assets are tax-exempt and taxable bonds. Issues of tax-exempt

PCIDBs displace taxable debt used to finance investment. While the government no longer collects tax revenue on the displaced taxable debt, it recovers some of the lost revenue because firms who use PCIDBs claim smaller interest deductions. The lost tax revenue on the displaced debt is considered the gross loss to the government, while the net loss includes the offset of lower interest deductions. Appendix B discusses this model and Data Resources' determination of the tax revenue impacts of PCIDBs.

The empirical results derived by Data Resources indicate the federal revenue losses from PCIDBs range from $700 million to $1 billion in 1982. Elimination of all PCIDBs issued after 1982 would raise revenues by $80 million in 1983, rising to $370 million in 1985. Assuming a liberal amount of economic feedback from the lost investment stimulus, the revenue gain would be $70 million in 1983, rising to only $250 million in 1985.

If PCIDBs were eliminated, most firms would seek financing through taxable debt. However, the Treasury would not necessarily recover the revenues lost in tax benefits to the bondholders. If investors replaced their investment in PCIDBs with fully taxable investments, the Treasury's loss would be minimized. However, a myriad of tax shelters is available to investors at different levels of risk and return. The rational investor can be expected to find the means of obtaining the return he desires at a level of risk he is willing to incur. To the extent investment in PCIDBs is replaced by investment in other tax-exempts or tax shelters, the loss to the Treasury remains the same. Unfortunately, given the small volume of PCIDBs outstanding, the data available makes it difficult for us to comment on the precise pattern of activity at the margin. It is likely, however, that most investors would find other means of sheltering their income if tax-exempt PCIDBs were not available.

CONCLUSION

PCIDBs represent a small percentage of all tax-exempt bonds sold, and a much smaller percentage of tax-exempt bonds outstanding. They are used only to pay for construction of pollution control facilities required to bring certain industries into compliance with federal environmental law. Because the tax laws permit the sale of PCIDBs at the lower interest rates associated with tax-exempt financing, PCIDBs represent a partial federal subsidy to these industries. The presence of these bonds in the capital market has the effect of raising interest rates. The effect is minimal because of the low volume of PCIDBs sold. PCIDB use results in a net tax revenue loss to the Treasury. If tax-exempt PCIDBs were eliminated, it is likely that most investors would find other means of sheltering their income. To the extent investment in PCDIBs were replaced by investment in other tax-exempts or tax shelters, the loss to the Treasury would remain the same.

APPENDIX A

A REVIEW OF EARLIER MODELS OF THE TAX-EXEMPT MARKET

The empirical literature on modeling the tax-exempt market is rather large.[1] This brief survey concentrates on the seven studies that are most complete or representative of the research done in this area. Only two studies have attempted to estimate a complete model - Peter Fortune and Patric Hendershott and Timothy Koch.[2] The other five studies estimated single equation models.[3]

The study by Peter Fortune indicates that much of the simultaneity in the tax-exempt bond market disappears in the estimation of his model. He found that the interest elasticity of his single supply equation is quite small so that his model collapses to two equations—one estimating commercial bank demand for tax-exempts and the other estimating the houshold demand for tax-exempts. The latter equation estimates the gap between the tax-exempt and taxable interest rate as a function of the excess tax-exempt supply. That excess supply is the volume of bonds not purchased by institutions which must be absorbed by the household sector. Thus, the household sector is the residual demand that equilibrates the demand and supply of tax-exempts. While Fortune found some interest elasticity in the commercial bank demand for tax-exempts, the elasticity was quite small. Adjustment by commercial bank demand reduced the interest rate impact by 6% to 9% of what it would have been if households had born the entire burden of adjustment.[4]

The model of Hendershott and Koch reported similar results. Hendershott and Koch found that the tax-exempt bond supply is inelastic with respect to interest rates in the long run. In the short run however, a 100 basis point increase in tax-exempt rates would force state and local governments to postpone 7% of their capital spending for structures.[5] They found that the demand by fire and casualty insurance companies is insensitive to relative tax-exempt and taxable interest rates. Commercial bank demand displayed a moderate sensitivity to relative interest rates but such adjustments disappeared after two years. The studies by Fortune and Hendershott and Koch indicate that in the long run, both commercial bank and fire and casualty demand is interest-insensitive and is determined by earnings that they have to shield from taxation.

The multi-equations of Fortune and Hendershott and Koch indicate that a $1 billion increase in the supply of tax-exempt bonds would raise tax-exempt rates by 5 to 8 basis points.[6] A later study by Hendershott estimates an interest rate effect of 9 basis points per billion dollars of new tax-exempt bond issues, when a modest level of tax-exempt bonds are offered.[7] The single equation model by Peterson indicates that a $1 billion increase in supply would raise tax-exempt rates by 4-7 basis points.[8] The final two studies found considerably higher and lower effects. The single equation model of Galper and Peterson estimated that a $1 billion increase in supply would raise tax-exempt rates by 13 basis points.[9] The single equation model of Kormendi and Nagle indicates that $1 billion increase in supply would raise tax-exempt rates by only 0.6 basis point relative to taxable rates.[10] This discussion of the interest rate impacts indicates a wide range of empirical estimates. The interest rate effect per billion dollars of increased supply ranges from 0.6 to 13 basis points, with most studies' estimates clustering around 6 basis points. The reasonableness of these estimates will be discussed later in this section.

The preceding studies discussed in this section lump IDBs with all other tax-exempts. However, it is likely that markets distinguish between these two kinds of tax-exempts due to varying risk perceptions and institutional factors. First, the yield differential between comparable IDBs and general obligation bonds is generally attributable to perceived differences in default risk. In general, IDBs as a class are perceived to be more risky due to the lack of any "full faith, credit and taxing" authority that is normally attached to general obligation bonds.[11] However, to recall from our discussion of task I, the risk of revenue bonds is perceived by investors to vary by the purpose of the bond. For example, based on Sorenson's study yields on IDBs and PCIDBs were 46 and 16 basis points higher than average for all revenue bonds.[12]

Institutional factors may also contribute to this market segmentation. In terms of supply, certain restrictions such as interest rate ceilings and voter approval apply to many general obligation bonds, while revenue bonds are less subject to such restrictions. On the demand side, restrictions on commercial banks induce a preference for general obligation bonds. Commercial banks prefer high quality tax-exempts as they are limited by regulatory agencies to high grade investments. Since proportionately more revenue issues are nonrated, banks have an enforced bias for general obligation debt. In addition, high transactions costs of complicated revenue bond issues reduce the attractiveness of revenue bonds. Finally, prohibitions against the underwriting of most revenue bonds further strengthen the bias against revenue bonds.[13]

Based on the single equation model of Kidwell and Koch, a $1 billion increase on revenue bonds relative to general obligations bonds raises the spread between revenue and general obligation bond by about 0.9 basis point, based on 1975 data.[14]

Other studies on PCIDBs and housing revenue bonds found much larger effects. Based on a model developed by Galper and Peterson, a $1 billion increase in PCIDBs in 1981 would raise the interest rate spread between PCIDBs and general obligation bonds by 15 basis points.[15] However, the Galper/Peterson estimate is based on a very small sample of 13 months in the mid 1970s. Peterson, in his study of housing bonds, found that a $1 billion increase in housing bonds raised the interest rate spread between housing bonds and other tax-exempts by about 6 basis points. Results for different time periods were relatively unstable. Peterson admits that much of the effect may be temporary, attributable to the unfamiliarity of investors with the new mechanism of housing bonds. He suggests that the volume of housing bonds had its most significant impact not on general obligation bonds, but on interest rates for other types of revenue bonds, which would be considered by investors to be closer substitutes.[16]

EMPIRICAL RESULTS

This final section presents the empirical results of a tax-exempt bond market model constructed for this task. The first part of this section describes the specification and estimation of each equation. The second part presents some simulation results from the entire model. To recall, a fully specified model would include 9 equations: three supply equations for state and local government bonds, PCIDBs, and all other IDBs; three demand equations for the purchases of fire and casualty companies, commercial banks, and all other institutions; and three interest rate equations - an interest rate equation that equates supply and demand by variations in household demand, an interest rate equation for PCIDBs and an interest rate equation for all other IDBs. Data from the flow of funds was used for much of the estimation, since it was the only data source that provided consistent data on the demand and supply of tax-exempt bonds.

SUPPLY OF STATE AND LOCAL BONDS

The supply of state and local government bonds is expected to be a function of a variety of factors. State and local governments issue bonds to meet any operating deficits and to finance capital spending. The timing and size of such borrowing is dependent upon the interest rate on state and goverment borrowing and economic factors such as GNP and the unemployment rate. A rise in the interest rate would reduce supply, while increases in GNP and declines in the unemployment rate would be expected to raise supply. Regressions were run on a variety of functional forms. In particular, a "real" or deflated supply equation was attempted but proved to be less satisfactory than running the regression in nominal terms. The most satisfactory equation (and the one used in the final model) was

LEAST SQUARES WITH FIRST ORDER AUTO CORRELATION CORRECTION
QUARTERLY (1961:1 TO 1981:4) 84 OBSERVATIONS
DEPENDENT VARIABLES: SLG@0BL*.004

COEFFICIENT	T-STATISTIC	INDEPENDENT VARIABLE
2.84718	1.336	CONSTANT
-0.243524	-1.795	DEFGSLO
0.0104677	4.477	GNP
-0.860804	-1.059	RMAAAGSLNS
0.468432	4.616	RHO

R-BAR SQUARED: 0.7240

DURBIN - WATSON STATISTIC: 1.8019

STANDARD ERROR OF THE REGRESSION: 3.569 NORMALIZED 0.285

SLG@OBL - net new issues of state and local government bonds, millions of dollars, seasonally adjusted quarterly rates (flow of funds estimate)

DEFGSLO - operating deficit of state and local governments, billions of dollars, seasonally adjusted annual rates

GNP - gross national product, billions of dollars, seasonally adjusted, annual rates

RMAAAGSLNS - Moody's AAA state and local government bond rate (new issues), percent

RHO - autocorrelation coefficient.

With the exception of the interest rate and constant term, all independent variables were significant at the 5% level. To test the stability of the coefficients, two tests were performed. First, the sample period was split into two sub-periods (1961:1 to 1971:2 and 1971:3 to 1981:4) and regressions were run over the separate subperiods. The coefficient on GNP ranged from 0.09 to 0.022; the coefficient on DEFGSLO ranged from -0.26 to -0.36; and the coefficient on RMAAGSLNS ranged from -1.26 to -1.27. Second, clearly some simultaneous equation bias was present in the ordinary least squares regression, as the interest rate and bond supply were simultaneously determined.[17] When a two-stage least squares regression was run, the coefficients were surprisingly robust.[18] The coefficient on GNP was 0.011; the coefficient on DEFGSLO was -0.25; the coefficient on RMAAAGSLNS was -0.98; and the coefficient on RHO was 0.48.

The results of these two tests indicate that results from the original regression are fairly robust and were thus the ones used in the final model. In particular, this equation indicates that the supply of state and local government bonds is very insensitive to variations in interest rates. A one basis point increase in the state and local interest rate would lower supply by less than $0.01 billion. This result is broadly consistent with the findings of Fortune and Hendershott and Koch, discussed earlier in this section.

SUPPLY OF PCIDBS

The supply of PCIDBs is expected to be a positive function of pollution control plant and equipment expenditures, and a negative function of the interest rate differential between PCIDBs and other municipal bonds. General economic conditions could have an effect but it should be rather weak, since such effects should already be captured by variations in pollution control plant and equipment expenditures. Coopers and Lybrand provided annual data on PCIDB's from 1973 to 1982 and monthly data from March 1978 to December 1980 and January 1982 to October 1982.

Regressions were run on the monthly data over the period 1978 to 1980. Unfortunately, monthly data on plant and equipment expenditures do not exist, so the regressions could only test the effects of general economic conditions and the interest rate differential. The interest rate differential was the difference between the yield on 30-year AA-rated PCIDBs and 30-year AA-rated IDBs, both gathered by Coopers and Lybrand. Unfortunately, the interest rate differential was statistically insignificant and the wrong (positive) sign. The indicators of general economic conditions such as the unemployment rate and the University of Michigan survey of consumer confidence yielded poor results.

Annual data yielded much better results. Unfortunately, the sample period of the regressions was quite short, 1973 to 1981, since pollution control expenditure data is available only over that period. Regressions with the annual data revealed that PCIDBs all closely related to pollution control plant and equipment expenditures, are mildly sensitive to changes in the interest rate differential, and are not sensitive to fluctuations in general economic conditions. The most satisfactory regression was:

ORDINARY LEAST SQUARES
ANNUAL (1973 to 1981) 9 OBSERVATIONS
DEPENDENT VARIABLE: PCIDB

COEFFICIENT	T-STATISTIC	INDEPENDENT VARIABLE
14.3603	2.328	CONSTANT
0.211650	1.376	PABE
-11.3939	-2.337	AA30PCDY/RMAAAGSLNS

R-BAR SQUARED: 0.6062
DURBIN-WATSON STATISTIC: 1.8854
STANDARD ERROR OF THE REOBSESSION: 0.5284 NORMALIZED: 0.1741

where

PCIDB - new issues of PCIDBs, billions of dollars
PABE - pollution control plant and equipment expenditures, billions of dollars
AA3OPCDY - yield on 30-year AA-rated PCIDB, percent
RMAAAGSLNS - interest rate, 20-year and over, AAA-rated state and local government bonds, percent.

Note that the T-statistic on PABE is low. Moreover, the interest rate ratio mixes yields of different quality and maturity, clouding the meaning of the coefficient. Nonetheless, this coefficient indicates that based on the average over the sample period, a one basis point rise in the PCIDB yield relative to the state and local government yield would lower PCIDBs by less that $0.02 billion.

The interest rate ratio term was dropped to determine the stability of the PABE coefficient. Not unexpectedly, the coefficient on PABE rose dramatically and the fit (R-bar squared) deteriorated.

ORDINARY LEAST SQUARES
ANNUAL (1973 to 1981) 9 OBSERVATIONS
DEPENDENT VARIABLE: PCIDB

COEFFICIENT	T-STATISTIC	INDEPENDENT VARIABLE
0.130835	0.1031	CONSTANT
0.394235	2.325	PABE

R-BAR SQUARED: 0.3552
DURBIN - WATSON STATISTIC: 1.9090
STANDARD ERROR OF THE REGRESSION: 0.6762 NORMALIZED 0.2228

Unfortunately, as we will indicate later in this section, we were unable to estimate a reasonable equation for the yield on PCIDBs. Without an equation for the yield, we had to rely on this simpler relationship in forecasting PCIDBs for calculating the revenue gains from eliminating PCIDBS in Appendix B.

SUPPLY OF ALL OTHER IDBs

The supply of all other IDBs is expected to be a negative function of the interest rate differential between IDBs and other municipal bonds and related to economic activity. The sign of the relationship to economic activity is unclear, but we might expect that IDBs activity would be counter-cyclical. When economic conditions worsen, firms would turn to lower costs of PCIDB financing. Coopers and Lybrand provided monthly data on total IDB financing from February 1978 to December 1980 and January 1982 to October 1982. Data on total IDBs was also available quarterly from 1971:1 to 1982:3 from the flow of funds.

Regressions based on the Coopers and Lybrand data indicate that total IDBs move counter-cyclically and are not sensitive to interest rate differentials.
The most satisfactory equation was

ORDINARY LEAST SQUARES
MONTHLY (1978:2 to 1980:12)
DEPENDENT VARIABLE: TIDBTR

COEFFICIENT	T-STATISTIC	INDEPENDENT VARIABLE
6135.26	3.907	CONSTANT
-2256.19	-4.824	JATTC
-2411.10	-2.475	JQIND

R-BAR SQUARED: 0.4006

DURBIN-WATSON STATISTIC: 1.9430

STANDARD ERROR OF THE REGRESSION: 232.1 NORMALIZED: 0.2372

where

TIDBTR - total new issues of IDBs, million of dollars, compiled by Coopers and Lybrand

JATTC - University of Michigan index of consumer confidence, 1966:1=1

JQIND - Federal Reserve Board index of industrial production, 1967=1

Unfortunately, the regressions run on the quarterly flow-of-funds data indicate much less counter-cyclical behavior. This means that conclusions drawn from the monthly data are not particularly strong.

DEMAND BY INSTITUTIONS

As discussed in an earlier part of this section, institutional demand for tax-exempts is a function of the income available to shield from taxation and the interest rates on tax-exempts relative to other assets. Regressions were run on the demands of commercial banks and fire and casualty insurance companies, the two largest institutional investors in tax-exempts. Data limitations and time constraints precluded a detailed investigation. Initial regressions were very poor. Inability to accurately estimate institutional demand does not appear to be a serious short-coming since more exhaustive studies in this area by Fortune and Hendershott and Koch indicate that institutional demand is insensitive to variations in the interest rate differentials. Thus the burden falls on the household to adjust the market and equilibrate the supply and demand of tax-exempts.

MARKET CLEARING INTEREST RATE (HOUSEHOLD DEMAND)

Our discussion in this section indicates that the household sector is the residual demand for tax-exempts. It is the sector that clears the market and equates supply and demand. This is then the most important equation in the model since it determines the sensitivity of tax-exempt interest rates to variations in supply and demand.

The equation is based on a simple model of household asset demand.[19] Households are interested in a desired stock of tax-exempt assets relative to their current asset position. Since there are costs of adjustment, households can move only a fraction of difference between desired and actual asset levels. In that case,

$$A_e - A_{e-1} = b(A_e^* - A_{e-1})$$

where

A_e - stock of tax-exempt assets
A_{e-1} - stock of tax-exempt assets, last period
b - speed of adjustment coefficient
A_e^* - desired stock of assets

If we assume a two-asset world of only taxable and tax-exempt assets, then the desired level of tax-exempt assets is a function of their relative interest rates and other factors such as age, income, and tastes. If, for simplicity, we omit the other explanatory factors, the desired level of tax-exempts is a function of relative returns or

$$A_e^* = f(r_e/r_t)$$

where

r_e - tax-exempt interest rate
r_t - taxable interest rate
f - functional relationship, assumed to be linear

So

$$A_e - A_{e-1} = bf(r_e/r_t) - b\,A_{e-1}$$

and with some substitution we can bring the relative interest rate term to the left hand side, or

$$r_e/r_t = A_e/bf - ((1-b)/bf)A_{e-1}$$

In the actual regression analyses, we deflated the stock of tax-exempts held by households by total financial assets held by households to avoid problems of heteroskedasticity. After considerable estimation, the most satisfactory equation was

LEAST SQUARES WITH FIRST-ORDER AUTO CORRELATION CORRECTION
QUARTERS (1961:1 to 1981:4) 84 OBSERVATIONS
DEPENDENT VARIABLES (RMAAAGSLNS/RMMBCAAANS)

COEFFICIENT	T-STATISTIC	INDEPENDENT VARIABLE
0.539269	7.707	CONSTANT
8.82330	3.744	HHES@LSLL/HH@AFINL
-2.03182	-0.8969	HH@SELSLL 1/HH@AFINL 1
0.861994	13.82	RHO

R-BAR SQUARED: 0.7669

DURBIN-WATSON STATISTIC: 1.5998

STANDARD ERROR OF THE REGRESSION 0.02193 NORMALIZED = 0.03147

where

RMAAABSLNS - interest rate on AAA rate state and local government bonds (new issues), percent

RMMBCAAANS - interest rate on AAA rated seasoned corporate bonds, percent

HH@SECSLL - stock of total tax-exempt bonds (including IDBs) held by households, millions of dollars, seasonally adjusted, (flow-of-funds)

HH@AFINL - total stock of financial assets held by households, millions of dollars, seasonally adjusted, (flow-of-funds)

This equation has a few difficulties. First, the coefficient on the lagged asset term is quite low. Second, the state and local government rate is a new issue rate and the corporate bond rate is a seasoned issue rate. Using a new issue corporate bond rate generated less satisfactory results but did not change the size of the interest rate sensitivity very much. Nonetheless, this coefficient indicates that, based on the average over the sample period, a billion dollar increase in the holdings of tax-exempts by households raises the tax-exempt interest rate by 2.1 basis points. The implied speed of adjustment coefficient is quite reasonable, 0.77—indicating that 77% of the difference between desired and actual holdings of tax-exempts is eliminated in one quarter.[20]

As with the equation for the supply of state and local government bonds, two tests were run of the original regression. First, the sample period was split into two equal sub-periods and regressions were run on the separate sub-periods. While the coefficients of the independent variables varied considerably, the maximum interest rate effect of a $1 billion increase in holdings by households was still less than 3 basis points. Second, the regressions were rerun using two-stage least squares. The equation suffered from simultaneous equation bias as the interest rate and household asset holdings are simultaneously determined. The two-stage least squares estimates were quite close to the ordinary least squares estimates with coefficients on the contemporaneous asset term of 8.16, the lagged asset term of 2.02, and RHO of 0.84.

Still, the interest rate effect is on the lower end of the scale of empirical estimates. The lower bound of empirical results is the findings of Kormendi/Nagle, who found an interest rate effect of 0.6 basis point. Kormendi/Nagle found that their estimate of the interest rate effect was robust over a wide variety of sample periods and estimation techniques. In particular, they criticized the model of Peterson that found an interest rate effect of 4-7 basis points. The Peterson model estimated the interest rate differential as a function of net new issues of tax-exempts purchased by households relative to total net new issues purchased by households. The problem with this specification is that if net issues of tax-exempts held by households rises and total net new issues held by households falls, then the state and local tax-exempt rate would fall and not rise, a seemingly paradoxical result. The Peterson model was reestimated by DRI finding an interest rate effect of only 1.4 basis points. Reestimation of the Kormindi/Nagle specification indicated an interest rate sensitivity of 1.8 basis points.

Another test of the reasonableness of interest rate senstivity is to compute the size of the interest rate increase large enough to eliminate the interest rate differential between tax-exempt and taxable bonds. In 1981:4, the differential between the two rates was 302 basis points. Using our regression results would require nearly a $150 billion increase in purchases by households. This would represent a shift of only 3.0% of total asset holdings of households and would be about 5 times the amount of tax-exempts issued in the period at an annual rate ($35.0 billion). Using an estimate of six basis points per billion dollars of net new issues held by households (the average of most empirical studies), the required increase to clear the market would be $50 billion of net new tax-exempts.[21]

INTEREST RATES ON PCIDBs AND OTHER IDBs

The final two equations in our model determine the interest rate on PCIDBs and all other IDBs. Previous empirical studies indicated that interest rates on IDBs require a premium over general obligation bonds due to higher perceived risk by investors. As discussed in an earlier section, it is expected that this premium or interest rate differential is a function of relative supplies of IDBs and general obligation bonds, and cyclical conditions in the economy. Regressions run over monthly or quarterly observations did not prove fruitful. The relative supply term was either statistically insignificant or of the wrong sign. The coefficients on the cyclical terms were generally of the right sign but insignificant.

SIMULATIONS WITH THE COMPLETE MODEL

For purposes of testing the interest rate sensitivity of the tax-exempt market, the model collapses to four equations: two supply equations, one demand equation, and an interest rate equation. Total supply is equal to the supply of net new issues of state and local government, which is endogenous, and total IDB's. This supply can be considered interest rate insensitive bonds, and hence exogenous. While PCIDBs were considered very midly interest rate sensitive, we were unable to link the interest rate of PCIDBs to other tax-exempt bonds. Hence, variations in the tax-exempt rate would have no effect on the supply of IDBs in this model. The demand of households equals the difference between total supply and demand by institutions. The final equation is the interest rate equation which equals total supply and demand by variations in household demand.

Total supply

(1) DOM@SECSL = SLG@OBL + NFC@SECSLP

Supply of State and Local Government Bonds

(2) SLG@OBL = F(DEFGSLO,GNP,RIMAAAGSLNS)

Demand by Households

(3) HH@SECSL = DOM@SECSL-DOM@SECSL@HH

Market Clearing Interest Rate

(4) RMAAGSLNS/RMMBCAAANS = F(HH@SELSLL/HH@AFINL, HH@SECSL 1/(HH@AFINL 1)

where

DOM@SECSL - total supply of net new issues of tax-exempts, millions of dollars, quarterly rate, flow-of-funds

NFC@SECSLP - net new issues of IDBs, millions of dollars, quarterly rates, flow-of-funds

HH@SECSL - net purchases of tax-exempts by households, millions of dollars, quarterly rates, flow-of-funds

DOM@SECSL@HH - net purchases of tax-exempts by institutions, millions of dollars, quarterly rates, flow-of-funds

Three additional equations close the model—an identity relating stocks of household holdings of tax-exempts (HH@SECSLL) to net purchases (HH@SECSL); an identity relating net purchases of tax-exempts (HH@SECSL) to total purchases of financial assets (HH@AFIN), and an identity relating total purchases of financial assets to the stock of total financial assets (HH@AFINL).

The traditional tests of model accuracy were carried out. The first test is the ability of the model to track history. A standard measure of this tracking accuracy is the mean absolute percent error (MAPE) which is the ratio of the difference between the actual and simulated value relative to the actual values. The MAPE statistics are quite good for this model and are presented below

(1961:1-1981:4)	MAPE
Total Supply (DOM@SECSL)	-8.3
Supply of state and local Govt. Bonds (SLG@OBL)	-10.1
Demand by Households (HH@SECSL)	21.0
Interest Rate (RMAAAGSLNS)	-2.2

Not unexpectedly, the MAPE statistic is highest for the purchases of households which was estimated as a residual.

The second test is the ability of the model to forecast beyond the same period (an ex post forecast). The model was solved for the period 1982:1 to 1982:3. This is a particularly difficult period for the tax-exempt sector. The top marginal tax rate of individuals was reduced from 70% to 50% effective January 1, 1982, exacerbating an already volatile period for financial markets. The model captured the sharp gyrations in the state and local government interest rate, as shown below

	81:4	82:1	82:2	82:3
State and Local Govt. Int. Rate (%)				
Actual	11.60	12.15	11.42	10.64
Simulated		11.80	11.40	10.71
Difference		0.35	0.02	-0.07

The third test is the interest rate sensitivity of the complete model. The model was first solved over the period 1976 to 1981. Then, the volume of IDBs is raised $250 million or $1 billion at an annual rate from 1976 to 1981. The difference between the two simulations indicates the interest rate responsiveness of the model to changes in tax-exempt supply, as shown in Table 4.1. The increase in IDBs by $1 billion generates an increase in household demand to clear the market. This causes a rise in the tax-exempt interest rate, which dampens the initial increase in total supply by reducing the supply of state and local government bonds. After four quarters, the tax-exempt was up 2 basis points, supply of state and local governments down $0.02 billion, and total supply up $0.98 billion. After 24 quarters, the tax-exempt rate is up 11 basis points, supply of state and local government bonds is down $0.1 billion, and total supply is up $0.9 billion.

APPENDIX B

ESTIMATES OF THE REVENUE LOSSES FROM PCIDBs

The estimates of the revenue losses from PCIDBs are developed from a multi-asset model developed by Harvey Galper and Eric Toder.[22] While the discussion will center on the simplest case of a model that ignores movements of capital between sectors, we will see that the revenue estimates are not seriously undermined by these simplications. In this two asset model, the only assets are tax-exempt and taxable bonds. Issues of tax-exempt PCIDBs displace taxable debt used to finance investment. While the government no longer collects tax revenue on the displaced taxable debt, it recovers some of the lost revenue because firms who use PCIDBs claim smaller interest deductions. The lost tax revenue on the displaced debt can be considered the gross loss to the government, while the net loss includes the offset of lower interest deductions. The revenue loss to the government per dollar of outstanding PCIDBs is

$$r_t t_b - (r_t - r_e) t_c$$

where

r_t - taxable bond rate

t_b - marginal tax rate of savers switching from taxable to tax-exempt bonds

r_e - tax-exempt bond rate

t_c - marginal tax rate of the firms holding PCIDBs.

It is important to point out that it is not the average marginal tax rate of the original purchasers that matters in the revenue loss calculations, but the marginal tax rate of those who experience net changes in their holdings of municipal bonds. It is the marginal rate of the marginal buyer who switches from taxable to tax-exempt bonds that should be used rather than the average marginal rate of all holders of municipal bonds. In the case of estimating the revenue gains from eliminating PCIDBs, this assumption is particularly valid since we are concerned with small changes to the stock of tax-exempt bonds. For example, in 1981, total new issues of PCIDBs represented only 1% of all tax-exempt debt outstanding in the flow-of-funds accounts. As we shall see later in this section, use of an average marginal tax rate generates larger revenue losses.

Note also that all of the benefits of tax-exempt PCIDBs are held by the firms, who are assumed not to lower their prices. This effect is dependent, of course, on the degree of competition in the industries comprising the PCIDB-holding firms.

The marginal tax rate, t_b, of the additional buyers of PCIDBs will be determined by the relative suppliers of taxable and tax-exempt bonds. Under the current progressive tax structure, tax-exemption is of most value to the highest-bracket saver. As the supply of tax-exempt bonds rises, the tax-exempt interest must rise relative to the taxable rate to attract additional savers from lower brackets. In equilibrium, for a given supply of taxable and tax-exempt bonds, the marginal buyer will be indifferent between the two types of bonds. At this equilibrium point, both types of bonds yield the same after-tax return for the marginal buyer,

or

$t_b^* = (r_t - r_e)/r_t.$

After some manipulation, the revenue loss per dollar can be expressed as

$(r_t - r_e) * (1 - t_c).$

To flesh out this argument, let us insert the 1981 values of the relevant variables $r_t = 15.0\%$, $r_e = 10.4\%$, and $t_c = 0.38$.[23] The revenue loss is then $0.029 per dollar of outstanding PCIDBs ($0.029 = (0.15 - 0.104)* (1 - 0.38). This revenue loss is equal to a gross loss of $0.046 per dollar due to reduced taxation of interest income minus an offset of $0.017 per dollar because of lower interest deductions claimed by firms.

The existence of other assets does not change the size of the revenue loss, under the assumption of fixed capital flows. For example, consider the case of three financial assets—one fully taxed, one partially taxed, and one tax-exempt. The maximization of after-tax returns by savers requires that the lowest-bracket savers hold taxable assets and the highest-bracket savers hold only tax-exempt assets. Savers in the middle tax brackets hold partially taxed assets, as the return on those assets earn an after-tax return higher than when holding tax-exempt or fully taxed assets.

When the supply of tax-exempt PCIDBs increases, the additional bonds will be purchased by relatively high-bracket savers who initially hold partially taxed assets. These partially taxed assets will be sold then to savers in lower tax brackets initially holding fully taxed assets. The revenue loss in this three asset case consists of two parts. The first is the loss because of the decline in holdings of partially taxed assets by high-bracket savers who purchase the additional tax-exempt bonds. The second is a loss because low-bracket savers exchange fully taxed assets for partially taxed assets. The sum of these two parts is equal to the loss using the two asset model. In the general case, the saver is indifferent between fully taxed and partially taxed assets when their after-tax returns are equal or

$$r_t\,(1-t_1{}^*) = r_p\,(1-at_1{}^*)$$

where

$t_1{}^*$ - marginal tax rate of the marginal holder of fully taxed assets

a - portion of income earned from partially taxed assets

r_p - interest rate on partially taxed assets

and

$$t_1{}^* = (r_t - r_p)/(r_t - ar_p)$$

For the marginal holder of tax-exempt bonds, the after-tax return on partially taxed assets equals the tax-exempt rate or

$$r_e = r_p\,(1 - at_2{}^*)$$

where

$t_2{}^*$ - marginal tax rate of the marginal holder of partially taxed assets

and

$$t_2^* = (r_p - r_e)/ar_p.$$

The revenue loss, L, per dollar of substitution of tax-exempt for taxable bonds is

$$L = t_1^* (r_t - ar_p) + t_2^* ar_p.$$

The first term is the loss from the change in the portfolio of lower-bracket savers from fully taxed to partially taxed assets, while the second term is the loss from the change in the portfolio of higher-bracket savers from partially taxed to tax-exempt assets. With some substitution,

$$L = r_t - r_e$$

which is the same as the loss in the two asset case from the substitution of tax-exempt for taxable assets in savers' portfolios.

This analysis has been criticized by Roger Kormendi and Thomas Nagle, who generated tax losses about half the size of Galper/Toder using a particular "domino effect" in the substitution of a partially taxed asset (equity) for a taxable asset (debt).[24] The major difference is their small revenue loss from the switch of equity for taxable debt. Kormendi/Nagle assume that equity sold by high-bracket households primarily substitutes for taxable debt in the portfolios of tax-exempt non-profit institutions and pension funds, with corresponding low revenue losses. The taxable debt is then purchased by financial institutions to cover the reduction in their tax-exempt debt (home mortgages). The flaw in the Kormendi/Nagle analysis is that, since the return on equity must rise relative to the taxable return for nonprofit institutions to hold more equity, many high tax bracket investors would also substitute equity for taxable debt. Allowing all equity holders to adjust their portfolios would make the Kormendi/Nagle revenue loss estimates much closer to the Galper/Toder estimates, since individuals hold most corporate equity.

The model developed so far has adopted what Galper/Toder refer to as the fixed allocation assumptions, i.e., that the elasticity of demand for pollution control plant and equipment is zero and the elasticity of demand for tax-exempt bonds is infinite. Under these unrealistic but simplifying assumptions, taxable and tax-exempt interest rates are unaffected and there are no changes in the allocation of capital from the movement of capital to the more tax-favored activity and away from other investments. Galper/Toder found that the revenue estimates are understated when interest rate and capital allocation are included. However, under plausible assumptions, Galper/Toder find that in the case of tax-exempt housing bonds, the degree of understatement is uncertain and may be small.

While the net effect is an understatement of the revenue loss, changes in interest rates increase revenue to the government. With a more realistic model, tax-exempt rates must rise to induce savers in lower tax brackets to purchase tax-exempt bonds. This switch by lower-bracket investors decreases the revenue loss from investors switching from tax-exempt to taxable bonds. Taxable rates also rise. An increase in tax-exempt PCIDBs increases the total value of desired plant and equipment because they lower its average cost. With a fixed supply of capital, the increase in demand is choked off by an increase in the taxable (and tax-exempt) rate. But tax-exempt rates will generally rise more so that the ratio of the tax-exempt to taxable interest rate will rise. The increase in the taxable interest rate raises revenues from all remaining holders of taxable debt; however, the rise in the taxable rate also lowers revenue because interest deductions claimed by firms who finance pollution control plant and equipment with taxable debt are higher. The net effect of the rise in the taxable rate is to raise revenue.

The preceding analysis indicates that a tax loss estimate under the fixed allocation assumptions of unchanged capital flows and interest rates is a reasonable approximation. Hence, the revenue losses presented in this study are estimated under these fixed allocation assumptions. In that case, the revenue loss from PCIDBs is equal to

$$(r_t t_b{}^* - (r_t - r_e) t_c) \text{ PCIDBL}$$

where

r_t - taxable interest rates

$t_b{}^*$ - marginal tax rate of the marginal saver switching from taxable to tax-exempt bonds

r_e - tax-exempt bond rate

t_c - marginal tax rate of the firm holding PCIDBs

PCIDBL - stock of PCIDBs outstanding

It is important to point out that these estimates rest on the model developed earlier that shows changes in tax-exempt debt ultimately displace taxable debt. The marginal buyer of PCIDBs would turn to taxable debt even though the average buyer of PCIDBs would continue to purchase some form of tax-exempt debt because of its tax advantages.

To generate annual estimates, the various variables assumed certain values. The taxable corporate rate r_t was assumed to be Moody's BAA corporate bond rate. This is the same assumption adopted by the CBO in their study of small issue IDBs.[25] The marginal tax rate, t_b^*, is equal to one minus the ratio of the tax-exempt to taxable bond rate. Both CBO and the Treasury assume that t_b^* assumes its historical average of 0.30. For our analyses, we have used the ratio of Moody's AAA state and local government new issue rate to a AAA corporate new issue rate computed by DRI. A lower-quality new issue series would have been preferable, but no such series existed in the DRI databanks. The marginal tax rate of firms holding PCIDBs is assumed to be 0.38. This is the average marginal tax rate of all firms, and is similar to CBO and Treasury assumptions.[26]

The stock of PCIDBs outstanding was derived from the annual PCIDB data gathered by Coopers and Lybrand. The current stock, PCIDBL, is assumed to be equal to the current level of PCIDBs plus the stock of PCIDBs in the last period, PCIDBL_{-1}. Some of the stock wears out over time, so a constant 5% depreciation rate was assumed, consistent with Treasury assumptions.[27]

$$\text{PCIDBL} = \text{PCIDB} + (0.95) * \text{PCIDBL}_{-1}$$

Since the first PCIDBs were offered in 1971, the stock of PCIDBs in 1970 was safely assumed to be zero. The 1972 estimate of PCIDBs was derived from the Treasury estimate.

The term $r_t\, t_b^*$ can be considered the gross per dollar loss from IDBs while the term $(r_t - r_e)\, t_c$ is the offset. This offset occurs because firms with PCIDB financing have higher taxable incomes since their borrowing costs are lower and hence they pay higher taxes. This assumes that firms do not lower their prices in response to their lower costs due to lack of competition or other factors. It is difficult to test the reasonableness of such an assumption, since little data is available on the distribution of PCIDB holdings by industry.

Estimates of the revenue losses of PCIDBs under varying assumptions are shown in Table B.1. Assuming an average marginal tax rate of 43%, which is similar to CBO calculations, the tax loss rises from -\$0.2 billion in 1972 to \$1.63 billion in 1981.[28] Assuming a constant marginal tax rate of 0.30 and no offset, as is assumed by Treasury and CBO, the revenue loss rises from -\$0.01 billion in 1972 to \$1.37 billion in 1982. In 1980, the estimate is \$0.81 billion, equal to

$$-\$0.81 = (.1367)(0.30)(\$19.71)$$

This is higher than the Treasury estimates because the Coopers and Lybrand estimates of PCIDBs are generally higher than Treasury's estimates. Using Treasury's estimates yields an estimate of -\$0.64 billion which is quite close to the Treasury estimate of \$0.635 billion for fiscal year 1980.[29] Assuming a variable marginal tax rate with no offset, the estimates are somewhat higher than in the constant marginal tax rate case. Assuming a variable marginal tax rate and the corporate tax offset, the estimates fall considerably (by 38%), rising from -\$0.01 billion to -\$0.66 billion in 1982.

Table B.2 shows the revenue gains from eliminating all PCIDBs issued after December 31, 1982. The assumptions are the same as in Table B.1 except that the taxable bond rate is assumed to be DRI's AAA state and local government new issue rate, since forecasted values of a BAA bond rate were not available. Forecasts of pollution control and equipment expenditures were taken from DRI's CONTROL122482 forecast. The forecast of PCIDBs was based on a simple linear

Table B.1

Static Revenue Losses of Pollution Control Industrial Development Bonds
(Billions of dollars)

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Static Revenue Losses											
Average Marginal Tax Rate*	-0.02	-0.09	-0.19	-0.32	-0.39	-0.49	-0.63	-0.81	-1.15	-1.63	NA
Constant Marginal Tax Rate**	-0.01	-0.07	-0.13	-0.22	-0.27	-0.34	-0.44	-0.57	-0.81	-1.13	-1.37
Variable Marginal Tax Rate***	-0.01	-0.08	-0.15	-0.21	-0.29	-0.41	-0.56	-0.75	-1.00	-1.15	-0.99
Variable Marginal Tax Rate With Offset****	-0.01	-0.05	-0.10	-0.14	-0.20	-0.27	-0.36	-0.49	-0.65	-0.74	-0.66
Under Treasury Assumptions*****	-0.01	-0.05	-0.10	-0.17	-0.21	-0.26	-0.34	-0.45	-0.64	-0.95	-1.11
Treasury Estimate (Fiscal Years)******	NA	NA	NA	-0.11	-0.16	-0.25	-0.34	-0.42	-0.64	-0.72	NA
Assumptions											
Pollution Control Plant and Equipment Expenditures	3.80	4.92	5.70	6.97	7.23	7.34	7.88	8.42	8.70	8.90	9.11
Pollution Control Industrial Development Bonds	0.90	2.09	2.18	2.53	2.66	3.07	3.48	2.89	2.92	4.09	6.07
Pollution Control Industrial Development Bonds Outstanding	0.99	2.66	4.73	7.00	9.31	12.71	15.56	17.67	19.71	23.41	28.30
Moody's AAA Corporate Bonds Rate (%)	8.16	8.24	8.50	10.61	9.76	8.97	9.49	10.69	13.67	16.04	16.11
Ratio of AAA State and Local Govt. to AAA Corporate New Issue Rate (%)	70.34	65.19	85.74	71.29	67.92	64.48	62.14	60.06	62.93	69.49	78.33
Average Marginal Tax Rate (%)	43.02	43.14	43.65	43.56	43.35	42.88	42.57	42.71	42.83	43.40	NA

*Assumes an average marginal tax rate of households of 50% and a marginal tax rate of all other holders of municipal bonds of 30%
**Assumes a 30% marginal tax rate, consistent with Treasury and CBO
***Assumes a variable marginal tax rate, equal to 1 minus the ratio of the AAA state and local govt. to the AAA corporate new issue rate
****Assumes a variable marginal tax rate, equal to 1 minus the ratio of the AAA state and local govt. to the AAA corporate new issue rate. Offset is equal to the reduced borrowing costs to firms from tax-exempt financing.
*****Assumes a 30% marginal tax rate and a lower stock of outstanding PCIBDs

Source: Data Resources, Inc. and U.S. Treasury, Office of Tax Analysis

Table B.2

Revenue Gains from Eliminating Pollution Control Industrial Development Bonds
(Billions of dollars)

	1983	1984	1985
Revenue Gains			
Static	0.08	0.20	0.37
Dynamic	0.07	0.16	0.25
Assumptions			
Pollution Control Plant and Equipment Expenditures	8.34	9.22	10.63
Pollution Control Industrial Development Bonds	5.69	6.11	6.67
Pollution Control Industrial Development Bonds Outstanding	5.69	11.52	17.62
Corporate Bond New Issue Rate (%)	10.30	10.12	10.53
Ratio of AAA State and Local Govt. to AAA Corporate New Issue Rate	0.86	0.83	0.80
Feedback Rule (%)	30.00	30.00	33.00

*Assumes a variable marginal tax rate, equal to 1 minus the ratio of the AAA state and local govt. to the AAA corporate new issue rate
**Assumes a variable marginal tax rate, equal to 1 minus the ratio of the AAA state and local govt. to the AAA corporate new issue rate. Feedback rule is adapted from CBO, Small Issue Industrial Revenue Bonds, p. 46.

Source: Data Resources, Inc.

relationship between PCIDBs and pollution control plant and equipment investment. This relationship was discussed in more detail in Appendix A.

Under these assumptions, the revenue gain rises from $0.08 billion in 1983 to $0.37 billion in 1985. These estimates are static, in that they do not incorproate the effects of changing income levels from the elimination of PCIDBs. The revenue gain from elimination is partially offset by the lower tax collections that occur when the stimulus effect of PCIDBs is withdrawn. The size of the stimulus, of course, depends on many factors. Such factors include the size of the substitution of PCIDB financed investment for investment that would have taken place anyway. Since pollution control investment occurs to meet mandated environmental quality standards, the size of substitution is probably quite large. The additional net investment that does occur would have multiplier effects of an uncertain magnitude. Such additional economic activity raises incomes that feedback to offset the initial revenue effects.

CBO has attempted to estimate such feedback effects from the elimination of small issue IDBs.[30] CBO estimates represent close to the maximum feedback effects that could be expected, as the assumptions adopted by CBO are biased upward. First, CBO estimates assume that firms' investment is highly sensitive to changes in interest costs. Second, the CBO estimates assume that elimination of IRBs has no effect on investments and financing costs in other sectors (the fixed allocation assumption). Clearly, increased volumes of small issue IRBs would raise tax-exempt rates to induce investors to hold IRBs. This would in turn raise rates on taxable assets to restore their appeal to investors. As interest costs rise, investment in the unsubsidized (and subsidized) sectors would fall.

With these caveats dynamic (with feedback), revenue gain estimates are also shown in Table B.2. It adopts a feedback rule similar to the CBO's. Economic feedback is assumed to reduce the static loss by 20% in the first two years and 33% in the third year. With feedback, the dynamic gain falls to $0.07 billion in 1983, and to $0.25 billion in 1985. It is important to note that this feedback rule does not include the offset presented in Table B.1. The offset from lower interest costs would apply to the portion of PCIDB financing that would otherwise occur. The higher the degree of substitution, the higher the offset effect, but the lower the feedback effect since the latter effect depends on the amount of net new investment. Because of the difficulties in estimating the offset effect, it is not included in the feedback effects.

FOOTNOTES

[1] A good review of the literature is Timothy Cook, "Determinants of Individual Tax-Exempt Bond Yields: A Survey of the Evidence," Economic Review, Federal Reserve Bank of Richmond, May/June 1982.

[2] Peter Fortune, "The Impact of Taxable Municipal Bonds: Policy Simulations with a Large Econometric Model, "National Tax Journal, March 1973, pp. 29-42; and Patric Hendershott, and Timothy Koch, An Empirical Analysis of the Market for Tax-Exempt Securites: Estimates and Forecasts, Monograph series in Finance and Economics, Monograph 1977-4, New York University, New York, 1977.

[3] Harvey Galper and George Peterson, "Tax-Exempt Financing of Private Industry's Pollution Control Investment, Public Policy, Winter 1975, pp. 81-103; Patric Hendershott, "Mortgage Revenue Bonds: Tax-Exemption with a Vengeance," in Herbert Kaufman, (ed), Efficiency in the Municpal Bond Market, The Use of Tax-Exempt Finance for Private Purposes, pp. 13-42; David Kidwell and Timothy Koch, "The Behavior of the Interest Rate Differential Between Tax-Exempt Revenue and General Obligation Bonds: A Test of Risk Preferences and Market Segmentation," Journal of Finance, March 1982, pp. 73-86; Roger Kormendi and Thomas Nagle, "The Interest Rate and Tax Revenue Effects of Mortgage Revenue Bonds;" and George Peterson, Tax Exempt Financing of Housing Investment, Urban Institute, Washington, D.C., 1979.

[4] As reported in Peterson, Tucillo and Weicher, "The Impact of Local Mortgage Revenue Bonds on Securities, Markets, and Housing Policy Objectives," p. 63.

[5] As reported in Peterson, Tucillo, and Weicher, "The Impact of Local Mortgage Revenue Bonds on Securities, Markets, and Housing Policy Objectives," p. 63.

[6] As reported in Peterson, Tucillo, and Weicher, "The Impact of Local Mortgage Revenue Bonds on Securities, Markets, and Housing Policy Objectives," p. 64.

[7] Patric Hendershott, "Mortgage Revenue Bonds: Tax Exemption with a Vengeance," p. 21. The estimate of 9 basis points per billion dollars equals the total increase in tax-exempt rates (64 basis points) with a limited ($7 billion) volume of new supply.

[8] George Peterson, Tax Exempt Financing of Housing Investment.

[9] Harvey Galper and George Peterson, "Tax Exempt Financing of Private Industry's Pollution Control Investment," p. 97.

[10] Kormendi and Nagle, "The Interest Rate and Tax Revenue Effects of Mortgage Revenue Bonds," p. 124.

[11] See, for example, Kidwell and Koch, "The Behavior of Interest Rate Differentials Between Tax-Exempt Revenue and General Obligtion Bonds," p. 75.

[12] Eric Sorenson, "Bond Ratings Versus Market Risk Premiums," p. 68; see also A. James Heins, "The Interest Rate Differential Between Revenue Bonds and General

Obligation Bonds," National Tax Journal, December 1962, pp. 399-405, and Michael Hopewell and George Kaufman, "Commercial Bank Bidding on Municipal Revenue Bonds: New Evidence, "Journal of Finance, December 1977, pp. 1647-56.

[13] These are the arguments made by Kidwell and Koch, "The Behavior of the Interest Rate Differential Between Tax-Exempt Revenue and General Obligation Bonds," pp. 75-76.

[14] Derived from Kidwell and Koch, "The Behavior of the Interest Rate Differential Between Tax-Exempt Revenue and General Obligation Bonds," p. 80.

[15] Derived from Galper and Peterson, "Tax Exempt Financing of Private Industry's Pollution Investment," p. 98.

[16] As reported in Peterson, Tucillo, and Weicher, "The Impact of Local Mortgage Revenue Bonds on Securties, Markets and Housing Policy Objectives," p. 65.

[17] This problem is dicussed in most standard econometrics textbooks. A good discussion is Michael D. Intrilligator, Econometric Models, Techniques and Applications, Prentice-Hall, Englewood Cliffs, New Jersey, 1978, pp. 375-79.

[18] Estimation by two stage least squares is discussed in Michael Intrilligator, Econometric Models, Techniques and Applications, pp. 384-402. The instruments chosen were population, exports, federal purchases, nonborrowed reserves, and a time trend. These are the same instruments as used in the 1981C DRI macro model. The particular estimation technique was developed by Ray Fair; see Ray Fair, "The Estimation of Simulataneous Equation Models with Lagged Endogenous Variabes and First Order Serial Correlated Errors," Econometrica, March 1970.

[19] See for example, Benjamin Friedman, "Financial Flow Variables and the Short-Run Determination of Long-Run Interest Rates," Journal of Political Economy, August 1977.

[20] With some manipulation, it can be shown that the speed of adjustment coefficient, b, is

$$b = -(cfb-1)$$

where c-coefficient on the lagged stock term; using the regression results,
$0.77 = -(2.03*(1/8.82)-1)$

[21] This is discussed in more detail in Kormendi and Nagle, "The Interest Rate and Tax Revenue Effects of Mortgage Revenue Bonds," pp. 127-129.

[22] Harvey Galper and Eric Toder, "Modelling Revenue and Allocation Effects of the Use of Tax-Exempt Bonds for Private Purposes," in Herbert Kaufman (ed) Efficiency in the Municipal Bond Market the Use of Tax Exempt Financing for Private Purposes, pp. 85-116.

[23] A marginal tax rate of 38% for corporations is used, very similar to the estimates used by the Congressional Budget Office (CBO) and the Treasury Department.

[24] Roger Kormendi and Thomas Nagle, "The Interest Rate and Tax Revenue Effects of Mortgage Revenue Bonds," in Herbert Kaufman, (ed.) Efficiency in the Municipal Bond Market the Use of Tax Exempt Financing for Private Purposes, pp. 117-148.

[25] CBO, "Small Issue Industrial Revenue Bonds," p. 89.

[26] See for example, U. S. Congressional Budget Office, "How Changes in Fiscal Policy Affect the Budget: The Feedback Issue," Special Study, Wash., D.C., June 1982, p. 70.

[27] Based on an informal telephone discussion with Thomas Neuberg, financial economist, U.S. Treasury Department.

[28] The CBO calculation uses 40%, as reported in, "Small Issue Industrial Revenue bonds," p. 41. The DRI estimate assumes that the marginal tax rate of households is 56%, taken from the data shown in Table F.1; the marginal tax rate of institutions is 38% as discussed previously. These respective tax rates are weighted by their shares of outstanding tax-exempts taken from the flow-of-funds.

Table F.1

Cumulative Percentage of Householdings of Tax-Exempt Bonds by Federal Marginal Income Tax Rate

Marginal Tax Rate (Percent)	Cumulative Percentage of Holdings
20	4.7
30	15.2
40	24.3
50	30.6
60	62.4
70	100.0

Source: Harvey Galper and George Peterson, "The Equity Effects of A Taxable Municipal Bond Subsidy," National Tax Journal, December 1973, p. 617; Ultimately Derived from Dorothy Projector and Gertrude Weiss, "Survey of Financial Characteristics of Consumers," Federal Reserve Bord, Washington, D.C., 1966.

[29] U.S. Office of Management and Budget, Budget of the United States Government, Fiscal Year 1981, Special Analysis G, Tax Expenditures, U.S.G.P.O., Washington., D.C., p. 226.

[30] See CBO, "Small Issue Industrial Revenue Bonds," Appendix E, for a detailed discussion of the methodology employed.

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Projector, Dorothy and Gertrude Weiss, *Survey of Financial Characteristics of Consumers*, Federal Reserve Board, 1966.

Mr. PICKLE. Thank you, Mr. Bean.

Now we have one other. Mr. Stephen Jelin is vice president of the Hills Department Stores, National Mass Retailing Institute.

The Hills Department Stores is from where, sir?

Mr. JELIN. Headquarters in Massachusetts, sir.

Mr. PICKLE. I have it now. Thank you.

Go right ahead, Mr. Jelin.

STATEMENT OF STEPHEN JELIN, VICE PRESIDENT, HILLS DEPARTMENT STORES, CANTON, MASS., ON BEHALF OF THE NATIONAL MASS RETAILING INSTITUTE

Mr. JELIN. Thank you, Mr. Chairman.

Mr. Chairman, members of the Ways and Means Committee, my name is Stephen Jelin. I am vice president of Hills Department Stores, a mass merchandising discount department store chain with 105 stores in 11 Mid-Central States.

We thank you for the opportunity to testify on behalf of the National Mass Retailing Institute [NMRI] in opposition to additional restrictions on the use of small-issue industrial development bonds. NMRI is a trade association representing 125 member chains in the discount retailing industry with approximately 8,700 stores nationwide, and over $65 billion in sales.

To save time, Mr. Chairman, I shall present only a brief summary of NMRI's position on industrial development bonds, but may I request that my prepared statement be placed on the record in full.

Mr. PICKLE. It will be so ordered.

Mr. JELIN. Thank you, Mr. Chairman.

NMRI believes that any cost to the U.S. Treasury in terms of forgone tax revenues as a result of the tax-exempt status of IDB's must be thoughtfully measured against the benefits derived from investments that otherwise would not have been made, including the Federal, State, and local tax revenues generated by such investments.

Of Hills' present 105 stores, 17 have been built with industrial development bonds. Most of these would probably not have been built at all had IDB financing not been available. In the past 3 years, years in which high interest rates have impeded economic growth, 14 of our 20 new stores were IDB financed.

Thus, during a period when many businesses were contracting and laying off workers, particularly in our hard-hit trade area, small issue industrial development bonds financed 70 percent of our new store construction and allowed Hills to grow by almost 23 percent.

There is no doubt in the minds of our senior management that our rate of new store expansion and of attendant new job creation would have been significantly lower and slower had Hills been denied access to IDB financing.

While some concerns have been raised that increased use of IDB's in recent years has resulted in a loss of Federal tax revenues, we believe that such concerns may shortsightedly assume that IDB financing simply displaces more traditional forms of financing, and that most investments would have been made anyway, even without IDB's. Such is not the practical reality in our industry.

The average brick and mortar cost for the average Hills store in recent years has been approximately $25 per square foot at union scale, or about $2 million for an 80,000-square foot prototype store. At current differentials, IDB financing reduces the rate of interest Hills has to pay for its capital expansion by 3 percent from conventional forms of borrowing. Assuming $2 million of brick and mortar and $700,000 of fixtures for an average store, we estimate that IDB's save us $80,000 per year per store in capital costs, or $1 per square foot, and of course, in recent higher interest years, that differential has been even greater and even more significant.

To an industry whose very cornertone is low gross margins, that difference in construction costs can well make all of the difference between building and growth and not building and no growth.

In analyzing the cost and benefits of small issue IDB's, Hills' experience in job creation and revenue generation at the Federal, State, and local levels may be somewhat helpful and instructive. Each Hills store takes from 4 to 6 months to build and employs from 40 to 100 construction workers at all times during that period. These are almost all local people working for local contractors.

Once completed, each Hills store hires roughly 150 entry-level trainees from the local community to create a permanent work force of about 125 workers. Many of these people are unskilled, untrained, and might otherwise be unemployed. We train them and teach them a new career. We also hire additional part time and seasonal workers, students, mothers who need and want to work, older job force reentrants, all of whose schedules require flexible work hours.

An average new store just described generates approximately $900,000 a year in payroll for the local community. That is $900,000 of payroll subject to Federal, State, and local taxation. Moreover, in some of the towns in which Hills has built stores in recent years, we have added from 1.6 to 2.75 percent to the assessed real estate valuation base, generating substantial additional property tax revenues.

And finally, these new jobs, and wages, and tax revenues have an acknowledged multiplier effect on the entire local community. We believe that cumulatively these benefits make IDB's a good investment for the Government.

The U.S. economy continues to face slowed economic growth, lagging productivity, and comparatively low rates of capital formation. This surely is not the right time to impose additional restrictions on the use of IDB's which have proven effective in encouraging new investments and in creating new jobs.

Congress imposed significant new restrictions on IDB's last year, including strengthened reporting requirements and public approval procedures. Congress should at least wait to assess the impact of those recent changes before considering additional changes in the laws diminishing this key job-generating seed money program.

Thank you for your attention, sir.

[The prepared statement follows:]

STATEMENT OF THE NATIONAL MASS RETAILING INSTITUTE PRESENTED BY STEPHEN JELIN, VICE PRESIDENT, HILLS DEPARTMENT STORE, CANTON, MASS.

I. Introduction

Mr. Chairman and distinguished Members of the House Ways and Means Committee, my name is Stephen Jelin, and I am Vice President of Hills Department Stores, a mass merchandise discount store chain that owns and operates 105 stores in 11 mid-central states. Hills' aggregate sales in 1983 will approach $1 billion, making it the 9th largest discount chain in the United States.

I am pleased to have this opportunity to testify on behalf of the National Mass Retailing Institute ("NMRI") in opposition to additional restrictions on the use of small-issue industrial development bonds ("IDBs"). NMRI is a trade association representing 125 member chains in the discount retailing industry with approximately 8700 individual stores in nearly every state and over $65 billion in annual sales. With continuing high interest rates plaguing the U.S. economy, NMRI member companies have found small-issue IDB financing an increasingly important means to finance store expansion and job creation.

II. Summary of Position

1. IDB financing is an important and efficient means to finance store expansion and job creation. Any cost to the U.S. Treasury in terms of foregone tax revenues as a result of the tax-exempt status of IDBs must be weighed against the benefits created by investments that otherwise would not have been made

-- including the federal, state and local tax revenues generated by such investments.

2. The Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") imposed significant changes in the law affecting small-issue IDBs, including reductions in the availability of accelerated depreciation for IDB-financed property, new reporting requirements, and strengthened public approval procedures. Congress should not impose further restrictions on small-issue IDBs at least until after Congress has had a chance to assess the impact of those changes already imposed under TEFRA.

3. Retailing is a labor-intensive industry which generates many more jobs per dollar of capital than almost any other sector of the economy. NMRI is adamantly opposed to any IDB restrictions that would discriminate against the retailing or commercial sectors in favor of the manufacturing or industrial sectors.

III. IDBs Serve An Important Public Purpose by Generating New Investment and New Jobs

The basic purpose of industrial development bonds is to permit state and local governments to encourage and stimulate economic growth and business investment in the communities in which the bonds are issued. This economic growth in turn provides further public benefits by encouraging additional economic activity and employment in the region. Indeed, much of this economic activity would not take place were it not for the availability of IDB financing. The example of Hills Department Stores in recent years may prove enlightening in this regard.

With our high-volume, low-margin and self-service format, Hills is reasonably representative of the entire mass merchandise, discount retailing industry. Our ability to survive, to grow and to create jobs in the communities in which our stores are located is predicated on the efficient allocation of resources and the ability to finance our capital needs at the lowest possible cost.

Of our present 105 stores, 17 have been built with industrial development bonds. Most of these would probably not have been built at all, had IDB financing not been available. In the past 3 years -- years in which high interest rates have choked economic growth -- 14 of our 20 new stores were IDB financed. Thus while many enterprises were contracting and laying off workers during this period, small-issue industrial development bonds financed 70% of our new store construction and allowed Hills to expand its growth by almost 25%. There is no doubt in the minds of our senior management that our rate of new store expansion -- and new job creation -- would have been significantly lower if Hills had been denied access to IDB financing.

While some concerns have been raised that increased IDB use in recent years has resulted in a loss of federal tax revenues, we believe that such concerns are short-sighted and based on faulty assumptions. In particular, such revenue cost projections are based on the assumption that IDB financing simply displaces more traditional forms of financing and that certain investments would be made with or without IDB-financing. Permit me to explain a few of the practical realities in the mass merchandising industry.

The average brick and mortar cost for the average Hills store in recent years is approximately $25 per square foot at union scale, or about $2 million for an 80,000 square foot prototypical store. At current differentials, IDB financing reduces the rate of interest Hills has to pay for its capital expansion by 3% over conventional forms of borrowing. Assuming $2 million of brick and mortar and $700,000 of fixtures for an average store, we estimate that IDBs save us $80,000 a year per store in capital costs. In higher interest years, this difference is even more significant. To an industry built on low gross margins, that difference in construction costs can well make the difference between building and growth and not building and no-growth.

In analyzing the costs and benefits of small-issue IDBs, Hills' experience in job creation and revenue generation -- at the federal, state and local levels -- is particularly instructive. Each Hills store takes 4-6 months to build, and employs 40-100 construction workers at all times during that period. These are almost all local people, working for local contractors. Once completed, each Hills Store hires about 150 entry-level trainees from the local community to create a permanent work force of about 125 workers. Many of these people are unskilled, untrained and might otherwise be unemployed. We train them and teach them a new career. We also hire additional part-time and seasonal workers -- students, older persons and mothers who need and want to work, but whose schedules require flexibility in work hours. An average new store just described generates approximately $900,000 a year in payroll for the local community in which the store is located -- $900,000 of payroll subject to federal, state and local taxation. Moreover, in some of the towns in which Hills has built stores in recent years, we have added from 1.6% to 2.75% to the assessed valuation base, thus generating substantial additional property tax revenues. Our stores also generate satellite development as well, encouraging still more investment and jobs. And finally, the jobs we create and the wages and tax revenues we generate by the construction of each new store have an acknowledged "multiplier" effect on the entire community in which they are located.

NMRI submits that the benefits created by such investments -- including federal, state and local tax revenues -- greatly outweigh the loss of any immediate federal tax revenues associated with the exempt status of the bonds themselves.

IV. Congress Should Wait to Assess the Impact of the Restrictions Imposed by TEFRA Before Considering Additional Restrictions on IDB Uses

As part of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), Congress voted to impose significant restrictions on the use of small-issue industrial development bonds. TEFRA provided, with certain exceptions, that property financed with IDBs must be depreciated on a straight line basis over ACRS cost recovery periods. The maximum term of bond issues was limited to 120 percent of the expected useful life of the property being financed. Moreover, to insure that the bonds would be used only for locally-approved public purposes, TEFRA imposed new procedures for public hearings and approval by elected officials. Finally, TEFRA established new reporting requirements for all private activity tax exempt bonds to ensure that decision makers obtained the necessary information and data to make informed policy choices with respect to uses of IDBs.

The irony is that, while the U.S. economy continues to face serious problems with respect to economic growth, productivity, capital formation and trade deficits, the Congress is considering imposition of even greater restrictions on a program that has proven effective in encouraging new investment, improving productivity, modernizing plant and equipment, and creating jobs. NMRI believes that additional restrictions on the use of small issue industrial development bonds are unwarranted and should not, at the very least, be considered until after the impact of the new TEFRA restrictions are fully assessed and understood.

V. Restrictions Which Would Limit IDB Uses to Industrial or Manufacturing Activities Would Unfairly Discriminate Against Retailers

Last year Congress considered certain legislative proposals which would have discriminated against retailers by limiting IDB use to industrial or manufacturing activities. NMRI strongly opposed these proposals last year and wishes to state for the record its continuing opposition to such proposals this year.

Investments in the retail sector of the economy are a significant source of new jobs. In fact, such investments stimulate much more permanent employment than do comparable investments in the manufacturing sector because retail businesses are more labor intensive than most manufacturing businesses. According to recent figures published by the U.S. Department of Commerce, the capital that must be invested for each employee in the manufacturing sector can range up to four times that required for each employee in the retail sector. */ The significant stimulation to employment provided by retail investment is also confirmed by a recent study prepared by Professors Benishay, Ginsburg and Lerner of Northwestern University.**/ That study concluded that a dollar invested in the retail sector is associated with three times as many permanent jobs as a dollar invested in the manufacturing sector.

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*/ Statistical Abstract of the United States, U.S. Department of Commerce, 1980, p. 561.

**/ "The Application of the Investment Tax Credit to Commercial Structures," Benishay, Ginsburg and Lerner, Northwestern University, 1977.

As we stated earlier in our testimony, investments in the retail sector serve important public purposes by providing many entry-level employment opportunities that would otherwise not exist. While many retailing employees are, of course, highly skilled and experienced, a large percentage of retail jobs can be filled by workers who are less skilled and experienced. For example, retailing requires large numbers of stockroom employees, materials handlers, maintenance personnel and clerks who can perform relatively routine duties. Moreover, through participation in in-house training programs, these employees can acquire the skills and experience necessary to permit them to advance to higher paying jobs in the retail sector or in other areas of the economy. In this way, investment in the retailing sector can help solve a pressing national problem by providing career opportunities for those without training and experience.

Most importantly, however, NMRI believes that individual state and local governments -- rather than the federal government -- are in the best position to determine the form and mix of economic development that is most desirable for their own respective areas. Continued local discretion to determine the appropriate uses of industrial development bonds is particularly appropriate in light of recent trends in federal policy. Both Congress and the Administration have placed increasing emphasis on local planning and self reliance and decreasing emphasis on federal spending to encourage economic development. Accordingly, NMRI believes it would be inappropriate for Congress to adopt any rules which would confine small-issue industrial development bonds to particular industries or geographic areas. In order to allow state and local government to fulfill their new responsibilities, it is essential that they continue to have the authority to determine the appropriate uses of small-issue IDBs.

VI. Conclusion

For the foregoing reasons, NMRI respectfully opposes any additional restrictions on the use of small issue industrial development bonds.

Mr. PICKLE. Thank you, Mr. Jelin.

Mr. Conable.

Mr. CONABLE. No questions. I thank the panel for your significant testimony.

Mr. PICKLE. Mr. Downey.

Mr. DOWNEY. No questions.

Mr. PICKLE. I did not get to hear the testimony of the first two gentlemen. I am still puzzled, not about the attractiveness of the IDB, Mr. Jelin, why the National Retail Association, or whatever your national group is—is that Mr. Lloyd Hackler's group?

Mr. JELIN. I am sorry, I did not hear you.

Mr. PICKLE. Your organization, the National Mass Retailing Institute, are you an affiliate of the National Retail Merchants Association?

Mr. JELIN. No; they are two different organizations although we collaborate at times.

Mr. PICKLE. You say that 70 percent of your stores are built through industrial development bonds.

Mr. JELIN. No, sir; I was at that point only speaking of Hills Department Stores, my company, from which one could generalize.

Mr. PICKLE. 125 stores that you built, 70 percent of them were built primarily through industrial development bonds?

Mr. JELIN. No, sir, 17 out of 105, but 14 of those out of 20 in the last 3 years. Seventy percent of our expansion in the last 3 years was financed by IDB's during a period of very high interest rates.

Mr. PICKLE. Your testimony is that unless we had the industrial development bonds, these stores would not be built? You would not have financed them at all locally?

Mr. JELIN. No; I could not say that, but would say this. As a member of management of the company, there is no doubt that expansion costs and capital allocation are a game of averages. Had we not been able to utilize IDB financing to average down our new store opening costs of the non-IDB stores, and note that only 30 percent in the last 3 years were non-IDB stores, we probably would have opened maybe three or four stores, certainly not 20.

Now, 17 unopened stores, quite frankly, would have meant 2,100 fewer jobs and about $15 million per year less payroll in the last 3 years, and those are taxable wages that would not have been paid in a trade area that consists entirely of upstate New York, western Pennsylvania, Ohio, Indiana. For, although our headquarters offices are in Massachusetts, our geographical center is Pittsburgh, and that is an area in which those jobs and those payrolls are very important.

Mr. PICKLE. Mr. Dorgan.

Mr. DORGAN. Mr. Chairman, I would like to ask a question of Mr. Jones who has, I think, given the committee a good description of the importance of the agribonds that have been used in North Dakota.

Mr. Jones, the Assistant Secretary of the Treasury, Mr. Chapoton, testified this morning before the committee, and he talked of an alternative to abolishing IDB's, the alternative being a statewide cap by State on the amount of bonds that might be used for one purpose or another, giving the State some flexibility to determine for what purpose they would like to use the bonds.

If the alternative here was either a dramatic curtailment of the use of IDB's or establishing some kind of a cap that would give the States some determination of whether they want to use it for agriculture purposes, for getting farmer loans or for mortgage subsidy loans or any number of things, the traditional private use IDB financing of a department store in Fargo or Bismarck, if there were some kind of a cap, would that be something that would be of great concern to you?

Mr. JONES. Congressman Dorgan, I imagine where that cap is would certainly have an effect.

Agribonds are new. This is our first issuance. The industrial commission and the legislature authorized it. We look at it—or at least I should say, Congressman Dorgan, I look at it—as a necessary tool that we need at this time of stress for agriculture. I also look at it as when and if the prices do come around for our commodities and our cattle, when the ag sector does recover, the need for it will be much less.

But it is crucial right now when we have 900 farmers facing bankruptcy in the State of North Dakota alone. Interest rates is the very thing that is our "Achilles heel." At this point, and probably for the next 2, 3, or 4 years, it would be an ideal thing to help us.

Now, if we have got to get into a wrestling match with a new K-Mart shopping center or some other endeavor—yes, I can see where the cap would be very difficult.

Mr. DORGAN. But if there has to be some limitation, if the administration's position would prevail that there be some limitation, it would be better for the State to make the decision on whether it wants to finance the new K-Mart or whether it wants to finance the agribonds.

Would you agree with that?

Mr. JONES. Well, of course, the State Industrial Commission is not involved in whether the city of Fargo or the city of Bismarck does indeed go out and put in a new shopping center. If the law is written so that happens, so that the State does make that decision, I can see some hairy fights coming up, that's for sure.

I do not look at the ag sector, at permanent long-term periods, having the need of agribonds, but I can sure see it for right now; everybody is in real stress and real trouble, and this is our basic industry. If ag goes down, everything goes down.

Mr. DORGAN. Is there ever a need to do some more specific targeting?

One of the things that has been discussed is targeting tax-exempt financing. Is there a need to do some targeting by size, for example, or asset basis?

Mr. JONES. Yes. I certainly would not like to see large corporations come in and take advantage of it and buy up whatever. That certainly should be one of the restrictions.

We had an $800,000 cap on our loans; I think the largest one was $600,000, and there was only one of those.

Yes, there should be an overall cap on the size.

Mr. DORGAN. Mr. Chairman, again, Commissioner Jones has given the committee a good description of why the agribonds are important to a rural economy, particularly in the period that we have faced, given the activities down at the Fed on interest rates.

We have seen the predictable and usual sources of credit literally dry up for some awfully good agricultural producers. The Industrial Commission of North Dakota has moved ahead with some agribonds. I think, again, Commissioner Jones has described to this committee why they are important and what they are used for and why most of us support them.

Thank you for your testimony.

Mr. PICKLE. Mr. Jones, I am going to reread your testimony. I found it interesting, in view of the fact that this morning I had earlier asked to be made part of the record a news release that was placed in my hand relative to the aggie bonds, or agribonds, in Virginia.

They had promoted there, the State legislature, the authority to sell some $650 million, as I remember the sum, and they advertised it and literally begged the farmers to come in. Out of the whole State, 18 of them signed up.

Now, in North Dakota, you had over 300, 338, or whatever your figure was. So I would have to ask you something. Why is that? Why is it so very successful as it has been in your State and why a complete washout here 100 miles from the capital?

Mr. JONES. I think, Mr. Chairman, that whether they are a banker or a businessman on Main Street, they realize that farmers really have their backs to the wall, and they are going to have to work their way out. For that reason, we indeed have 41 banks across the State of North Dakota participating.

Let me say in defense of the other States, if they have had trouble, it is a tremendous learning program, the process that must go on, of what this program entails, what the costs are going to be, how it works and so forth.

Once we finally got through with the learning program and the farmers and the bankers figured out what it was like and how it would work, and the benefit to the farmer and also the businessman on Main Street, we found that it went very quickly. But up to that point, it was sort of "What is this? I do not understand it, and so, therefore, I do not want to use it."

Mr. PICKLE. The bond is for the purpose of allowing the farmer to make a loan, I presume?

Mr. JONES. Yes.

Mr. PICKLE. To buy land for speculation purposes?

Mr. JONES. No. In our case, the way we ran it, the 41 bankers that ended up participating are the ones who do the collecting, are responsible and select which farmers get the loans—not for land speculation but to pick up an extra 80 acres that is available next door.

But there again, nearly 80 percent of our money in this bond issuance went for machinery, new and used, and for livestock improvement, not for land.

Mr. PICKLE. As I said, I will certainly read your testimony again because I like to read where it has been successful and has served a good purpose.

I also suspect that most of these aggie bonds are promoted by big investment houses.

Mr. JONES. Promoted?

Mr. PICKLE. Yes.

Mr. JONES. Not in our case.

Mr. PICKLE. I am glad to hear that.

Mr. JONES. In fact, probably the way it worked out, all the troubles we had, the reverse is true. But this was not the case in North Dakota.

Mr. DORGAN. Mr. Chairman, let me ask one other question, if I might.

This morning Mr. Chapoton, the Assistant Secretary, seemed strongly in opposition to extending the ability to use FDIC and FSLIC guarantees. If the administration were to prevail, what would it do to the ag bond issues?

Mr. JONES. Mr. Chairman and Congressman Dorgan, it would eliminate the good rating we got, it would raise the interest rates and therefore make it not usable.

Mr. DORGAN. Do you have any estimate of how much it would raise the interest rates?

Mr. JONES. Oh, I could not guess. I guess I would have to go to more expertise, but it would certainly raise it up in the area where there would not be the savings and the business then would not be transacted because they are not doing it in any stretch of the imagination now under the present interest rates they are paying, and as soon as the agri bonds get near it, they will also quit. Right now it is 13½ percent to 14 or 14½ percent.

Mr. DORGAN. Thank you.

Mr. PICKLE. Mr. Bean, are you the one that testified about the PCIDB's?

Mr. BEAN. That is correct.

Mr. PICKLE. I notice in this report by Coopers and Lybrand, the group that you employed to make your study, they said that Data Resources, the group that made the study, concluded that a $1 billion increase in tax-exempt borrowing would raise tax-exempt interest rates by about two basis points relative to comparable tax rates. They tell me that amounts to a good deal of money. Do you know how much that amounts to?

Mr. BEAN. I could not calculate what it amounts to, but two basis points on $1 billion would be a considerable amount of money. But I believe that the relationship being made is that for each increase in $1 billion of PCIDB financing, the general regular GO financing would increase only by I think two basis points, relative to corporate tax rates.

Now, the two basis points increase relates to the size of the GO issue itself.

Mr. PICKLE. I found that interesting.

I thank you, panel, very much, and we are not going to prolong the questioning period because we have other panels. But we are glad to have all your testimony, and your entire statements will appear in the record.

Thank you very much.

Now the Chair asks Mr. Paul Casowitz and Mr. Mike Cooper to be the next panelists. If they will come forward.

Mr. Casowitz is the deputy commissioner of the Department of Sanitation for the City of New York. Mr. Cooper is the director of technology programs, the National Solid Waste Management Association.

Mr. Casowitz, we will be pleased to receive your testimony.

STATEMENT OF PAUL CASOWITZ, DEPUTY COMMISSIONER, DEPARTMENT OF SANITATION, RESOURCE RECOVERY AND WASTE DISPOSAL PLANNING, CITY OF NEW YORK, AND ON BEHALF OF THE NATIONAL RESOURCE RECOVERY ASSOCIATION OF THE U.S. CONFERENCE OF MAYORS

Mr. Casowitz. Thank you very much, Mr. Chairman.

I am here representing both the City of New York and the National Resource Recovery Association of the U.S. Conference of Mayors. On behalf of Mayor Koch and Sanitation Commissioner Norman Steisel and the government officials of the 150 local jurisdictions of the NRRA, I would like to express our appreciation for this opportunity to voice the problems H.R. 1635 presents for resource recovery development.

Mr. Chairman, I know you have had a long day, and since my testimony is in writing, with your permission I would like to summarize it rather than to read it in full.

Mr. Pickle. Your entire statement will be made a part of the record.

Mr. Casowitz. New York is not unique among the nation's cities in having a solid waste problem. I think it is universal throughout the country. I guess the only thing that makes New York special is the magnitude of our problem.

We currently dispose of over 6.7 million tons of garbage—and I might add that we generate well over 8 million tons, some of that being disposed in neighboring States. Eventually, as their waste disposal facilities close, that garbage is going to come home to us.

Over the years we have seen a secular attrition of the city's waste disposal capacity. I think as an elected official you will understand that it is a lot easier to allow a facility that handles garbage to close down than to build a new one.

New York is facing the end of the road. By the end of 1985 we will have one landfill left, and that will last us about 14 to 18 years depending on how much garbage we can stuff into it. And that is not a lot of time in the public works arena. In order to keep that landfill open, we are going to have to build hills some 500 feet in height. But there is an answer for New York City, and there is an answer for the other cities, and that is waste energy development.

This is technology that has been demonstrated in western Europe and Japan and has been found to provide an environmentally safe means of waste disposal while at the same time recovering valuable energy from the garbage.

I might add that it is both national policy and New York State policy to advance resource recovery as a favored waste disposal alternative.

Now, one of the problems in developing resource recovery to replace our landfills is that these facilities are tremendously capital intense. For every thousand tons of daily capacity an investment of approximately $100 million is required. That means for New York

City in today's dollars over the next decade we are going to need about a $2 billion capital program.

It is worth noting that despite this capital requirement, the energy revenue production that is projected from these facilities creates about $2 on a present value basis for every dollar of capital investment, so that resource recovery has the effect of displacing energy imports and creating local construction jobs.

The advantages that IDB financing offers to municipalities is that it allows us to enter into full service agreements with the private sector for the development of waste-to-energy plants. Generally, these involve a competitive procurement where a city will identify its waste disposal needs, identify a site, and solicit proposals for firms to come in to design, construct, and operate a waste disposal facility, and to assume the technical risks of their proposal.

IDB financing also allows us to negotiate with private companies for equity contributions in return for tax benefits. Those tax benefits that go to the private company directly aid the city by reducing the city's need to raise funds.

I think that you would all agree that there is no more public purpose than picking up and disposing of the garbage. The IDB financing here is really fulfilling that public purpose.

I might also add that unlike some of the other projects that you have discussed here today, there is a self-limit on the amount of solid waste facilities that any municipality or county is going to build. No one is going to build more garbage disposal than they need, and it is a very democratic problem. We all generate about our own five pounds per capita, and it is universal throughout the country.

I know that there has been some discussion of a cap on IDB financing, and I might add that solid waste should be exempted from that kind of cap. It is simply not necessary because waste disposal projects are self limiting. Also, for most municipalities this is a one-shot investment. They are going to build the plant, it is going to last them for 30 years, and it is tough enough to get a garbage disposal facility approved and sited without having to compete against perhaps more attractive economic development projects.

The financial and the contractual arrangements that we are discussing here involving the private sector in handling a public problem I think represent the kind of creative and innovative approach that the country is looking for to deal with our critical waste disposal problem.

I thank you for the opportunity to testify.

[The prepared statement follows:]

STATEMENT OF DEPUTY COMMISSIONER PAUL CASOWITZ, NEW YORK CITY DEPARTMENT OF SANITATION

TESTIMONY

I am Paul Casowitz, Deputy Commissioner of the New York City Department of Sanitation. I am pleased to appear before this committee as a representative of both New York City and the National Resource Recovery Association (NRRA) of the U.S. Conference of Mayors. On behalf of Mayor Koch, Sanitation Commissioner Norman Steisel and the government officials of the 150 local jurisdictions of the NRRA, I would like to express appreciation for this opportunity to voice the problems H.R. 1635 presents for resource recovery development.

New York City is facing a full-scale waste disposal crisis. Given the rate at which landfills are being depleted and the long lead-time in bringing into operation resource recovery facilities, the day is fast approaching when there will be no place to dispose of the City's refuse.

The Department of Sanitation disposes of 6.7 million tons of solid waste each year. Approximately half that waste goes to Fresh Kills landfill. Other City landfills receive around 40 percent and City incinerators take the remainder.

In addition to the waste received at the City's own landfills, approximately another one million tons are disposed at New Jersey landfills by the private carting industry. As New Jersey landfills become depleted and access to them more restricted most of this waste, if not all, can be expected to be disposed of within the City.

After 1985, Fresh Kills landfill on Staten Island will be the City's only remaining landfill.

Our most optimistic projections show that, even with the extensive capital and operating improvements now being planned for this landfill, we will be extremely fortunate if Fresh Kills lasts to the year 1996.

Lack of space and stringent environmental requirements make it impossible to site new landfills within the City. Disposal of waste outside the City is not feasible as other municipalities are understandably restricting the importation of garbage.

While the magnitude of New York's waste disposal problem makes the City unique, the problem of providing environmentally compatible and cost-effective waste disposal is common to the entire country, and most particularly to the more densely populated urban areas.

In terms of both environmental impact and cost, resource recovery is the best available means of waste disposal. For these reasons the City commenced its resource recovery program, and approximately 50 projects are today in some stage of development nationwide.

The City's program calls for constructing, as quickly as possible, three facilities to compensate for the landfill closures in 1985, and five to nine additional facilities before Fresh Kills is depleted, and to preserve some capacity at Fresh Kills for incinerator residue and waste that cannot be burned. How long Fresh Kills will actually last will depend upon how much resource recovery capacity is developed, and how quickly.

Resource recovery offers the best alternative to existing refuse disposal methods because it reduces the volume and tonnage of refuse while recovering energy and useful materials. Revenues from the sale of recovered energy and materials are used to offset the municipal cost of waste disposal. Unfortunately, no technology exists today which can cover capital and operating costs with these revenues alone. The shortfall must be made up by a disposal fee which is paid by the waste disposer.

Resource recovery is very capital intensive. The construction cost of 1,000 tons of daily capacity is approximately $100 million today. For New York City, which will require approximately 20,000 tons of daily capacity during the next decade, this amount is staggering. When the cost of money used during the construction period is taken into account, the capital cost will be in excess of $2 billion, before inflation.

Yet, despite this capital requirement these projects will displace almost two dollars worth of energy imports over their operating lives for each dollar invested.*

Unfortunately, even with this attractive energy revenue prospect, high finance costs impede these projects.

The advantage of IDB financing is that it enables municipalities to enter into arrangements with the private sector whereby the private sector assumes substantial project risks, costs and benefits. The tax benefits available to the private sector can be transferred to the project in the form of a cash contribution. The private contribution directly reduces the disposal costs that must be borne by the local taxpayer.

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*This assumes energy prices will remain constant in real dollar terms and that future energy revenues are discounted to arrive at a net present value.

IDBs are critical for this transaction because State constitutions prohibit many municipalities, including New York, from entering into these types of transactions if general obligation bond financing is involved.

Existing law permits IDB-financed resource recovery projects to receive both the full ACRS depreciation benefits and the ITC, as long as the developer/cperator assumes substantial project risks.

TEFRA recognized the importance of the ACRS for solid waste disposal projects. An exemption from the ACRS trade-off in TEFRA was provided. H.R.1635 would remove this exemption.

The proposed legislation would reduce the depreciation allowances for IDB-financed equipment and buildings from the present five- and 15-year ACRS basis to an eight- and 25-year straight-line basis.

This change could so reduce the value of tax benefit transfers as to effectively eliminate the value to municipalities of financing waste disposal projects with IDBs.

This change undermines a locality's efforts to privatize, where possible, government services.

This change discriminates against these essential public works projects which are such a vital component of a municipality's infrastructure. Unlike other infrastructure projects solid waste is totally lacking of federal support.

This change discriminates against the private developer/operator which assumes all the risks and benefits required for ACRS depreciation allowances, and which would be entitled to these benefits if the project were not a public works project entitled to tax exempt financing.

Describing a typical arrangement between the private and public sector may best illustrate the manner and extent to which municipalities would be penalized by the proposed legislation.

A full service contract is executed whereby a private party contracts to construct and operate a facility with performance guarantees sufficiently strict to protect the interests of both the bondholders and the municipality, which must rely on the facility for its waste disposal needs. For these commitments the contractor receives a negotiated operations fee, usually tied to inflation. In addition, the operator, or a third party, can make a cash contribution to the project. The basis for such a contribution would be the anticipated tax benefits that can be realized by the contractor, such as the investment tax credit and ACRS depreciation benefits.

The full service contract procurement method is designed in recognition of the fact that the private sector is better able to assess and absorb the risks of both the complex technology and large capital investment associated with resource recovery.

The private sector assumes the risk of constructing the facility and meeting performance guarantees for the duration of the operating contract. Services are provided on the basis of a firm price bid (not cost plus) and the municipality does not guarantee the operator's profit.

With IDB project financing, the municipality does not provide a general guarantee of debt service. Bondholder security and the marketability of the bonds rests primarily on the performance guarantees of the developer/operator.

Concern has been raised over the proliferation of IDBs and the possible negative impact this may have on federal revenues and interest rates available for municipal general obligations. There is no indication that IDB financing for resource recovery will contribute to this problem.

In contrast to other IDB-financed projects, solid waste disposal facilities will be a limited investment. Municipalities will only invest in facilities to the extent they are needed to dispose of their refuse. Because these projects are self-limiting there is no need to include them in a proposed bond volume cap. Further, resource recovery projects are difficult enough to do without placing them in competition with economic development projects. Also, it would be impossible to develop a cap that would be equitable because of the varying stages of project development among communities.

Recognizing the need for this type of facility, its high capital cost, and the demands of other infrastructure needs on local borrowing power, the New York State legislature gave localities the authority to use project financing and enter into joint public/private ventures to develop solid waste management facilities.

The financial and contractual arrangements with the private sector which the City of New York and so many other municipalities are planning for resource recovery represent precisely the kind of creative alternative to traditional public finance and management which the President has called for in his drive to reduce the size and cost of government in the United States.

Thank you for the opportunity to testify.

Mr. PICKLE. Thank you, Mr. Casowitz.

Mr. Cooper, we would be pleased to hear your testimony.

STATEMENT OF MICHAEL B. COOPER, DIRECTOR, TECHNOLOGY PROGRAMS, NATIONAL SOLID WASTES MANAGEMENT ASSOCIATION

Mr. COOPER. Good afternoon, Mr. Chairman, and members of the committee. I, too, will be brief this afternoon.

Communities have two basic choices in refuse disposal: they can either bury it or they can burn it.

Members of our association will help them do either one of those. However, we believe that incineration with energy recovery best serves the public purpose intended by Congress.

We believe that H.R. 1635, if enacted as it currently stands, would mandate a continuation of refuse disposal in landfills. I come to you today to report our experience of the past 12 months.

We have seen five projects financed and construction began on those five, four financed using the special provisions provided and intended for use by the Congress through TEFRA.

Our members have told us that they would not have invested in those projects in this manner had investment incentives not been available. These projects would not have been under construction today had these investment incentives not been available. Eventually they would have been built, but the cost to those communities would have been significantly higher.

The public purpose of the solid waste disposal exemption for IDBs, which you crafted last year, is being achieved. We perceive this purpose to be, first, the commitment to provide for environmentally sound solid waste disposal facilities, and second, to seek energy independence.

Prompted by these initiatives we are now seeing a definite move at the State and local levels to adopt adequate facilities for solid waste disposal. Currently more than 200 communities are planning waste-to-energy projects which will help solve their disposal problems and provide for an energy component to offset the disposal costs.

Approximately 20 major projects are under construction or in operation today. At least a dozen more are approaching the contractor selection and financing stage. The continued availability of tax incentives for resource recovery, the policy clearly emphasized by this committee and the Congress last year, is directly responsible for this progress being made.

The facilities now being examined and built have the objective of reliable day in, day out disposal of solid waste. Communities have three generally available alternatives to finance a project: general obligation bonds, industrial development bonds or industrial development bonds with private sector participation.

Two communities have financed their facilities—one about 3 years ago and one recently—using revenue bonds with no private sector participation. Four others have selected and obtained private sector participants.

It is this ability to choose from a variety of financing alternatives that must be retained for use by municipalities. It is unrealistic to assume that communities will be able to pay for a project simply by passing through the increased costs of garbage disposal to residential and commercial waste generators. The passthrough costs, generally in the form of increased dumping fees, stop projects when they are no longer competitive with landfills. Energy revenues, under the best of circumstances, for the first few years are insufficient to lower these costs to competitive levels.

Four private and public sector projects financed without question have shown that the private investments have been used to lower disposal fees to acceptable levels.

I would like to point out that these projects, which are Westchester County, N.Y., Baltimore County, Md., North Andover, Mass., and Lawrence and Haverhill, Mass., have other very definite public purpose fallouts in which the private sector plays a part.

First, the developer, the operator, and the equity participant are the same company which has a large interest in making this project work. This interest was absent in several previous and ongoing waste-to-energy projects, which is very unfortunate. This interest assures the community needing the service that the project will dispose of their garbage reliably and in an environmentally safe manner, which is the objective of the project in the first place. There is one entity responsible to the community for that project.

Second, the availability of tax incentives which are used to attract private investors represents the appropriate Federal commitment and participation toward achieving the twin objectives of effective treatment and disposal of solid waste and the recovery of energy—commitments which Congress established in the Solid Waste Disposal Act and the Energy Security Act. Enactment of H.R. 1635 would essentially countermand the Federal commitment to these objectives.

Please recall that we, the association, vigorously opposed and continue to oppose the use of Federal grants, loan guarantees, price support loans, and other instruments to assist resource recovery projects. We believe they encourage and reward adventurers who competed for projects against legitimate private sector corporations, corporations which possess the technical and financial basis to compete and complete a project and make it work.

I would like to make one last point. These projects create new jobs.

We believe that elimination of tax incentives would be a severe setback for municipalities attempting to make environmentally desirable choices about waste disposal. In effect, it would be a de facto mandate by Congress for long-term reliance on landfills, which is an exact reversal of our present policy.

On behalf of NWSMA I want to thank the committee for the opportunity to present this statement.

[The prepared statement follows:]

Statement of Michael B. Cooper, Director, Technology Programs, National Solid Wastes Management Association

Good morning Mr. Chairman and members of the Committee. My name is Michael Cooper, Director of Technology Programs of the NATIONAL SOLID WASTES MANAGEMENT ASSOCIATION. Our members provide waste collection and landfill disposal services. They also provide complete resource recovery services including systems design, construction and operation. All these systems can help meet the national need for environmentally safe waste disposal and energy development.

Communities have two basic choices in refuse disposal: either bury it in the land or burn it. Where economics allow, disposal by incineration with energy recovery best serves the public purpose intended by Congress. We believe H.R. 1635, if enacted, would mandate a continuation of refuse disposal in landfills. Our members will also meet that mandate.

Last year we provided testimony to this Committee showing that communities would be able to finance waste-to-energy projects through private sector participation because the overall costs to the community would be significantly lower. At that time we believed elimination of tax incentives to attract private investors to participate in these projects was a bad idea. The Congress agreed that these projects indeed served a strong public purpose and exempted solid waste disposal facilities from restrictions placed on industrial development bonds through the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982.

We come to you today to report our experience of the past twelve months. Your judgment of last year was sound. Since then we have seen five projects financed and construction begin, four financed using the special provisions provided and intended for use by the Congress through TEFRA. Our members have told us that they would not have invested in these projects in this manner had investment incentives not been available. These projects would not be under construction today had these investment incentives not been available. Eventually they would have been built but the cost to those communities would have been significantly higher.

The public purpose of the solid waste disposal exemption for IDB's which you crafted last year is being achieved. We perceive this purpose to be: First, the commitment expressed by Subtitle D of RCRA in 1976 to provide for environmentally sound solid waste disposal facilities and; second, the commitment expressed by the Energy Security Act of 1978 to seek energy independence. Prompted by these initiatives, we are now seeing a definite move at the state and local levels to develop adequate facilities for disposal of solid waste. Currently, more than two hundred communities are planning waste-to-energy projects which will help solve their disposal problems and provide for an energy component to help off-set disposal costs. Approximately twenty major projects are under construction or in operation. At least a dozen more are approaching the contractor selection and financing stage. The continued availability of tax incentives for resource recovery, the policy clearly emphasized by this Committee and the Congress last year, is directly responsible for the progress being made.

Solid waste disposal facilities today represent a unique partnership between the private sector and the public sector at the local, state and federal levels. Let me explain this relationship because it is key to why I am here today.

The local community has a responsibility to ensure that solid waste disposal occurs in an environmentally safe and cost effective manner. The environmental standards are established by state and federal regulatory agencies. However, about three-fourths of all refuse collection is performed by the private sector. Both collection and disposal costs are increasing due to rising energy prices for transportation and rising construction costs to make landfills environmentally safe. Today, private companies are usually able to finance landfill site acquisition and construction costs. This is not true for major resource recovery facilities whose costs can approach $250 million.

Rising costs and the inability to find long-term environmentally safe areas for landfill within their boundaries have moved many communities to examine disposal alternatives which may be economical in the long run. Most alternatives being examined today center around a waste-to-energy facility of some type. The facilities now being examined and built have the objective of reliable day-in, day-out disposal of solid waste. Financing these facilities, however, has proven to be difficult.

Communities have three generally available alternatives to financing a project: General obligation bonds; industrial development bonds; or industrial development bonds with private sector participation. Two communities have financed their facilities, one about three years ago and one recently, using revenue bonds with no private sector participation. Four others have selected and obtained private sector participants. It is this ability to choose from a variety of financing alternatives that must be retained for municipality use.

A major problem for many communities is that they are absolutely limited in the amount of debt they can incur. Their capacity is limited under the best of circumstances and the past few years have been far from good for the financial condition of many local governments. It is also unrealistic to assume that communities will be able to pay for a project simply by passing through the increased costs to residential and commercial waste generators. The pass through costs, generally in the form of increased dumping fees, stop projects when they are no longer competitive with landfills. Energy revenues under the best of circumstances in the first few years are insufficient to lower these costs to competitive levels.

In order for local officials and the taxpayers to make the decision to invest in what may be the largest single capital project for their community, disposal fees must be reasonable and competitive with other disposal options. If they are not, the community will continue land disposal. The four private/public sector projects financed have shown without question that the private investments have been used to lower the disposal fees to acceptable levels.

Adoption of the provisions of H.R. 1635 would bring an abrupt halt to the timely development of future projects at the precise point that these first projects are struggling to their feet with the aid of these legislated incentives.

I would like to point out that the four projects, (Westchester County, New York; Baltimore County, Maryland; North Andover, Massachusetts; and Lawrence and Haverhill, Massachusetts), have other very definite public purpose fall-outs in which the private sector plays a part. First, the developer, the operator and the equity participant are the same company which has a large interest in making the project work. This interest was absent in several previous and on-going waste-to-energy projects with very unfortunate results. This interest assures the community needing the service that the project will dispose of their garbage reliably and in an environmentally safe manner which is the objective of the project in the first place. There is one entity responsible to the community for the project.

Second, the availability of tax incentives which are used to attract private investors represents the appropriate federal commitment and participation towards achieving the twin objectives of effective treatment and disposal of solid waste and recovery of energy, commitments which Congress established in the Solid Waste Disposal Act and the Energy Security Act. Enactment of H.R. 1635 would essentially countermand the federal commitment to these objectives.

Please recall that we vigorously opposed and continue to oppose the use of federal grants, loan guarantees, price support loans and other similar instruments to assist resource recovery projects. We believe they encourage and reward adventurers who competed for projects against legitimate private-sector corporations possessing the technical and financial basis to complete a project and make it work. Communities also contributed to the problem by lining up, hoping for federal funds and delaying the solving of their solid waste problems. We are pleased that these programs are for the most part unfunded by Congress.

I would like to make one last point. These projects create new jobs. It typically takes 3-4 years to build and place into operation a waste-to-energy facility. The construction contractor will employ up to 200 workers during this period. When completed, these facilities will employ 60-70 full-time staff. They will commence returning taxes to the Treasury as soon as construction begins. They will all still require a landfill and its employees for residue and shut-down periods. They will still require all of the collection personnel, both private sector or public sector to bring the refuse to the facility. And they will solve part of the solid waste disposal problem.

We believe that elimination of existing tax incentives would be a severe setback for municipalities attempting to make environmentally desirable choices about waste disposal, and in effect would be a *de facto* mandate by Congress for long term reliance on landfills, an exact reversal of our present policy.

On behalf of NSWMA, I want to thank the Committee for the opportunity to present the statement.

I would be pleased to answer any questions that you may have.

Mr. PICKLE. Well, we thank you, Mr. Cooper. We thank both you gentlemen.

I would yield to my New York colleague.

Mr. CONABLE. Thank you for your testimony, gentlemen.

I take it that there is a good deal of private sector involvement in solid waste disposal nowadays, particularly through the problems of the magnitude facing New York City.

I guess both of you gentlemen are saying that we would not be able to put together these deals if we did not have the tax incentives, the IDB's, the accelerated depreciation opportunities, and so forth that are available to lure the private sector into the process. Is that right?

Mr. CASOWITZ. Mr. Cooper and I have somewhat different perspectives. I represent the municipality, and he represents the industry.

Mr. CONABLE. But you are working together apparently in many cases.

Mr. CASOWITZ. We are running together. I think most everybody recognizes that the advancement of resource recovery is something that is desirable for the country, desirable for our local communities.

The capital intensive projects, they are expensive. Like any type of major industrial facility they are hard to site, they are hard to get local approval. There are a lot of obstacles, and there are high costs of entry into the business. So that any incentives that can be provided to both reduce the initial costs for the municipality increases competition, advances these projects, and helps us to reap the benefits of those projects earlier.

Ultimately, the garbage has to be taken care of, and if we wait long enough, I guess under a crisis situation we will do something. I do not envision a situation where we are not going to pick up the garbage. It is just do we start moving now, do we start moving while we still have some time, or do we operate under a crisis situation where we have to tolerate noncomplying landfills in order for facilities to be built.

Mr. COOPER. I would like to second what Mr. Casowitz said. In talking to our members who are the ones that are building and operating these facilities, they have indicated that they would not be investing in those facilities had these incentives not been available. And what that really means is that those projects would not be under construction today.

Mr. CONABLE. We do have a problem of the pyramiding of incentives. Maybe that is not a problem because the more incentives you have, the easier it is to entice private sector people into it. But of course IDB's provide a benefit, as do the writeoffs available and, let us say, in the energy credits that are available under the proper circumstances. You have a pyramiding of credits to the point where the Federal Government is providing a wide range of subsidy through tax and in other ways.

I guess that is where we run into trouble here. There seems to be no limit to the ingenuity of people who put together these deals in order to find enticements for private sector people. And, of course, it is a public purpose as we mentioned. That is the problem.

So far we have tended to try to find ways to exempt public purposes from limitations that we would impose otherwise. I guess you see our dilemmas here, just as we see the desirability of getting this done in one way or another. It is part of the social contract to pick up the garbage, as Mr. Casowitz said.

What did you want to say, Mr. Cooper?

Mr. **Cooper**. If I could comment on that, we are really answering the need that Congress expressed both for environmentally sound solid waste disposal and for energy recovery. And we feel that the Federal Government, and we have battled the Federal Government in the past against grants and loan guarantees and these types of things, we feel that this is an appropriate level of participation by the Federal Government in seeing those two objectives are met as far as solid waste disposal goes.

Mr. **Conable**. Thank you, gentlemen.

Mr. **Casowitz**. If I might, I would just like to add that there is a self-limitation, as I said. No community is going to build more garbage disposals——

Mr. **Conable**. That is a good point. It is not a competitive thing, is it?

Mr. **Casowitz**. And the other thing is we are behind. There are European cities with 50 percent and more of the waste being processed in waste energy facilities. I think in this country we are still under 6 percent.

Mr. **Conable**. Well, we have more land, but that is not the condition around New York City, I will have to say. The solid waste disposal there has simply become a staggering burden.

Mr. **Downey** [presiding]. Gentlemen, thank you. We do not want the garbage gap to open too wide between ourselves and the Europeans.

Thank you.

The next panel is Mr. Sheiner from ConEd, Mr. Fuller from the San Diego Gas & Electric Co., Mr. Eugene Waters from the New York State Electric & Gas Corp., Mr. Richard Mannix from Brooklyn Union Gas Co., and Mr. Preeshl from Miller & Schroeder.

Gentlemen, welcome. Our apologies for keeping you here so long.

Mr. **Conable**. Congratulations on your survival.

Mr. **Downey**. You now know what a full day before the Ways and Means Committee looks like.

Mr. Sheiner, we will hear from you first.

STATEMENT OF JONATHAN R. SHEINER, ASSISTANT TO THE VICE PRESIDENT, CONSOLIDATED EDISON CO. OF NEW YORK, INC.

Mr. **Sheiner**. My name is Jonathan Sheiner. I am assistant to the vice president of Consolidated Edison Co. of New York.

In the 1968 Revenue Act, Congress enacted a comprehensive industrial development bond legislation intended to restrict the use of these types of financing to relatively small issues. Excepted from the small issue limitations were IDB financing for certain facilities considered to be beneficial to the general public. Among the facilities so excepted were those intended to be used for the local furnishing of electric energy or gas. As interpreted by the Treasury regulations which were subsequently issued, local furnishing was defined as an area no greater than two contiguous counties. Subsequently, in 1978, Congress enacted legislation to include a city and a contiguous county within the definitions of local furnishing for electric energy. In 1982, Congress again amended the local furnishing provision by extending the city-county rule to gas and the availability generally of this IDB financing to district heating under the local furnishing exception.

The local furnishing provisions of the tax law allow facilities owned by investor-owned utilities to be financed with IDB's issued by government bodies or agencies. By excepting from the small issue limitation financing for facilities which provide electric, gas, and heat to customers in a limited geographic area, Congress has provided comparable financing to that available to municipal utilities performing similar services for the benefit of their customers.

But in addition to the limitations placed on IDB financing by TEFRA, public utility property generally has not fared too well under the last two tax acts. Under ERTA, most public utility operating properties were assigned an ACRS life of 15 years, longer than that assigned to the property of most other industries. Also, the repeal of the repair allowance was harmful to most utilities, whereas its effect on other commercial and industrial taxpayers was minimal. Under TEFRA, the reduction in tax basis of property by one-half the amount of the investment tax credit taken, coupled with the effect of capitalizing the real property taxes and interest relative to the construction periods of nonresidential real property is expected to materially increase the tax burden on our capital-intensive industry. In addition, TEFRA made public utility property completely ineligible for safe-harbor leasing.

Now there is a movement to further limit IDB's. The most significant proposals would either stretch the depreciation period for such IDB financed facilities or place limits on the amount of IDB's that could be issued annually within each State. Both proposals would adversely affect utility customers if applied to IDB's to finance facilities for the local furnishing of electricity, gas, or district heat.

So we believe that tax treatment for such IDB's should remain as it emerged from TEFRA for the following reasons:

IDB's for the local furnishing of electric, gas, and district heating directly serve a broad public interest. They have a character much more like general purpose bonds than private purpose IDB's which directly benefit only a limited portion of the community. All the benefits of local furnishing IDB's are directly passed to consumers who are virtually the same as the community at large.

The volume of local furnishing bonds will be small. Between 1984 and 1986, it has been estimated that about $1.4 billion in bonds will be issued, probably more likely about $1 billion in bonds will be issued.

The revenue loss for such IDB financing should be relatively small, probably less than $100 million over this same 3-year period. With the spread between tax free and conventional financing now running about 200 to 250 basis points, local furnishing IDB's are a reasonably efficient means to provide a benefit to utility customers with a relatively small revenue loss.

Of the utilities that can take advantage of local furnishing IDB's, ConEdison, Brooklyn Union Gas, San Diego Gas & Electric, and Hawaiian Electric, because of local operating conditions and other excessive uncontrollable costs, are among those public utilities having the highest rates for utility services in the country. Any relief that can be obtained for their customers must be pursued. The savings from IDB's is passed straight through to the utility customers in the capital structure of the company. Lower debt costs lower the required rate of return. None of the savings are going to go to the stockholder.

As indicated above, the 1981 and 1982 Tax Acts were not kind to utilities. In many respects these two acts left the electric and gas utility industry worse off than it was in 1980. It may be well into the 1980's before many utilities will be able to show a net benefit from the two Tax Acts, and this despite the dividend reinvestment program. Reducing the benefits of IDB's will only make it more expensive for the eligible utilities to raise the capital necessary to serve their customers.

Any argument that a user of these type of IDB's is double-dipping in the case of public utility companies has been reduced significantly by the lack of many of the tax benefits enjoyed by other sectors of industry. As a result, the economic value of using IDB's for utility facilities has been reduced to where it is somewhat less than the economic value was prior to ERTA and TEFRA.

Congress enacted the industrial development bond program to provide broad public benefits and economic development. We believe IDB's for the local furnishing of electricity, gas, and district heat serve these purposes very effectively. Their value should not be diminished any further.

Thank you.

[The prepared statement follows:]

STATEMENT OF JONATHAN R. SHEINER, ASSISTANT TO THE VICE PRESIDENT, CONSOLIDATED EDISON CO. OF NEW YORK, INC.

In the Revenue Act of 1968 Congress enacted comprehensive industrial development bond (IDB) legislation intended to restrict the use of this type financing to relatively small issues. Excepted from the small issue limitations were the IDB financing of certain facilities considered to be beneficial to the general public. Among the facilities so excepted were those intended to be used for the "local furnishing of electric energy or gas". As interpreted in the Treasury Regulations, which were subsequently issued, "local furnishing" was defined as an area no greater than two contiguous counties. Subsequently, in 1978 Congress enacted legislation to include a city and a contiguous county within the definition of local furnishing for electric energy. In 1982, Congress again amended the local furnishing provision by extending the city-county rule to gas and the availability generally of IDB financing to district heating under the local furnishing exception.

The local furnishing provisions of the tax law allow facilities owned by investor-owned utilities to be financed with IDBs issued by governmental bodies or agencies. By excepting from the small issue limitation financing for facilities which provide electric, gas and heat to customers in a limited geographic area, Congress has provided comparable financing to that available to municipal utilities performing similar services for the benefit of their customers.

In addition to the limitations placed on IDB financing by TEFRA, public utility property generally has not faired too well under the Economic Recovery Tax Act of 1981 (ERTA) and under TEFRA. Under ERTA most public utility operating properties were assigned an ACRS life of 15 years, longer than that assigned to the property of any other industries. Also the repeal of the repair allowance was harmful to most utilities, whereas its effect on most other commercial and industrial taxpayers was minimal. Under TEFRA, the reduction in tax basis of property by one half of the amount of the investment tax credit taken, coupled with the effect of capitalizing the real property taxes and interest relative to the construction periods of non-residential real property, is expected to materially increase the tax burden on our capital intensive industry. In addition, TEFRA made public utility property completely ineligible for safe-harbor leasing.

Now there is a movement to further limit IDBs. The most significant proposals would either stretch the depreciation period for such IDB financed facilities or place limits on the amount of IDBs that could be issued annually within each state. Both proposals would adversely affect utility customers if applied to IDBs to finance facilities for the local furnishing of electricity, gas or district heat.

Tax treatment of IDBs for the local furnishing of electricity, gas and district heating should remain as it emerged from TEFRA for the following reasons:

1. IDBs for the local furnishing of electricity, gas and district heating directly serve a broad public interest. They have a character much more like general purpose bonds than private purpose IDBs which directly benefit only a limited portion of the community. All the benefits of local furnishing IDBs are directly passed on to consumers who are virtually the same as the community at large.

2. The volume of local furnishing bonds will be small. Between 1984 and 1986 it has been estimated that about $1.4 billion in bonds could be issued under Section 103 (b)(4)(E) of the Internal Revenue Code for the local furnishing of electricity, gas and district heat. More than likely only about $1 billion will be issued.

3. The revenue loss attributable to IDB financing of local facilities for electricity, gas and district heating should be relatively small; less than $100 million over the entire 3 year period from 1984 to 1986. With the spread between tax free and conventional financing now running about 200 to 250 basis points, local furnishing IDBs are a reasonably efficient means to provide a benefit to utility consumers with a relatively small revenue loss.

4. Of the utilities that can take advantage of local furnishing IDBs, Con Edison, Brooklyn Union, San Diego Gas and Electric and Hawaiian Electric, because of local operating conditions and other excessive uncontrollable costs, are among those public utilities having the highest rates for utility services in the country. Any relief that can be obtained for their customers must be pursued. The savings from IDBs is passed straight through to the utility customer in the capital structure of the company. Lower debt costs lower the required rate of return. None of the savings go to the stockholder.

5. As indicated above, the 1981 and 1982 Tax Acts were not kind to utilities. In many respects these two acts left the electric and gas utility industry worse off than it was in 1980. It may be well into the late 1980s before many utilities will be able to show a net benefit from the two Tax Acts; this despite the dividend reinvestment program. Stripping the benefits of IDBs will only make it more expensive for the eligible utilities to raise the capital necessary to serve their customers.

6. Any argument that a user of IDBs is double dipping in the case of public utility companies has been reduced significantly by the lack of many of the tax benefits enjoyed by other sectors of industry. As a result the economic value of using IDBs for utility facilities has been reduced to where it is somewhat less than the economic value of using such bonds prior to ERTA and TEFRA. The significantly longer depreciation period of 15 years, the loss of the repair allowance and the disproportionately heavy impact on utilities of capitalization and interest and taxes during construction all reduce the advantage of using IDBs for utility facilities to a greater degree than for most other types of less capital intensive facilities. Moreover, the limited use of IDB financing permitted under the local furnishing exception in reality competes only with municipally operated utilities which are not subject to federal income taxation at all.

Congress enacted the industrial development bond program to provide broad public benefits and economic development. IDBs for the local furnishing of electricity, gas and district heat serve these purposes very effectively. Their value should not be dimished any further.

Mr. PICKLE [presiding]. Thank you, Mr. Sheiner.

Mr. Fuller from the San Diego Gas & Electric Co.

STATEMENT OF RONALD K. FULLER, VICE PRESIDENT OF REGULATORY SERVICES, SAN DIEGO GAS & ELECTRIC CO.

Mr. FULLER. Thank you, Mr. Chairman and members. We appreciate the opportunity to make this statement today.

My name is Ron Fuller and I am vice president of regulatory services for San Diego Gas & Electric Co. I am responsible for all company regulatory functions, regulatory affairs, risk management, rates and valuation, and revenue requirements.

I ask that my full testimony be placed in the record, and out of respect for your time and to avoid reiterating points made by my able colleague here from New York, I will try to keep my statement very brief.

The local furnishing of electricity and gas is in the broad public interest as distinct from certain other IDB applications. These services literally affect the health and welfare of the public.

There are regions of the country where, through no fault of the consumers or distributors, the fuel options have been limited. In most cases this is a result of regulatory constraints. These are the areas where rates are the highest. Often that is in the Northeast and in the Southwest, including southern California. These are also the areas where energy costs are especially impacted by external political events such as the oil embargo of 1973.

The Federal system has programs which selectively assist areas of the program which suffer from various economic problems. While I do not subscribe to or suggest that there should be such a program for consumers where utility rates are the highest, I do urge that no action be taken by the Congress to further restrict the benefits of IDB financing for the local furnishing of electricity and gas. This would only further exacerbate an already serious economic hardship.

The availability of IDB financing, even in its already much-restricted form, helps mitigate an inequity which exists between the cost of energy to consumers served by municipal and private utilities.

Throughout the Nation, as you know, many private utilities share contiguous service area boundaries with municipals. The municipals' consumers, of course, enjoy the cost benefit of municipal financing. Congress should not further restrict IDB financing for the local furnishing of electricity or gas and thereby indirectly discriminate economically against the consumer living on the private utility side of that boundary.

I want to conclude by suggesting that we should recall that Congress in recent legislation has seen fit to repeal or restrict various tax benefits to public utilities. Energy consumers have paid the price for that action. By not taking action now, as envisioned by H.R. 1635, the Congress will be helping to stabilize utility rates in those areas of the country where IDB financing can be utilized.

Gentlemen, in all the matters we have discussed that relate to the local furnishing of electricity and gas, we should remind ourselves that we are talking about direct consumer costs or savings.

We are not talking about profit margins, benefits for shareholders, or management in general. Electric and gas energy consumers are the public, and many are suffering from extremely high rates.

We ask that Congress join with those of us in the utility industry in helping to stabilize those rates. You can do that by preserving the existing IDB financing for the furnishing of electricity and gas.

Thank you very much.

[The prepared statement follows:]

STATEMENT OF RONALD K. FULLER, VICE PRESIDENT, SAN DIEGO GAS & ELECTRIC CO.

My name is Ronald K. Fuller. I am Vice President - Regulatory Services of San Diego Gas & Electric Company ("SDG&E"). I am responsible for all company regulatory functions, which include regulatory affairs and programs, risk management, rates and valuation and revenue requirements.

SDG&E appreciates the opportunity to present testimony on the industrial development bond issues and related legislation.

SDG&E is an investor-owned utility engaged in generating, purchasing and distributing electric energy to approximately 2 million people in San Diego and Orange Counties, California, and in purchasing and distributing natural gas to approximately 520,000 customers in San Diego County.

POSITION

It is SDG&E's position that industrial development bond ("IDB") financing of projects for local furnishing of electricity and gas, provides significant benefits to the general public. Using IDBs, qualified investor-owned utilities can finance projects which provide essential services, affecting the health and welfare of the public, at lower debt costs which in turn reduce rates, to their consumers. The benefits of SDG&E's IDB financing program do not inure to its shareholders; to the contrary, they are passed directly through to the utility customer.

Recent changes in the federal tax law have eroded many of the beneficial aspects of IDB financing. This form of raising capital has thus become less attractive. Further restrictions or limitations on IDB financing programs for local furnishing of electricity and gas will result in a loss of benefits to utility customers and the public at large.

BACKGROUND

In 1968, Congress enacted legislation restricting the use of industrial development bonds to relatively small issues. However, excepted from the small issue limitation was the IDB financing of certain facilities considered to be beneficial to the general public. Among the facilities so excepted are those which provide the "local furnishing of electric energy or gas." The Treasury Department has interpreted local furnishing to cover an area no greater than two contiguous counties the so called two-county rule. Subsequent legislation included a city and a contiguous county within the definition of local furnishing of electric energy. In 1982, Congress amended the local furnishing provision by extending the city-county rule to gas and by allowing IDB financing for district heating under the local furnishing exception. By excepting financing for those facilities which provide local furnishing from the small issue limitation, Congress has provided comparable financing and benefits to those which is already available to municipal utilities performing similar services for their consumers.

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) placed new restrictions on the allowable tax depreciation for property financed with IDBs. TEFRA replaced 15-year accelerated depreciation for public utility property with 15-year straight-line depreciation. As a result, IDB financing provides less benefit to our customers due to the loss of tax savings from accelerated depreciation. Proposed legislation, H.R. 1635, would further lengthen the straight-line depreciation period from 15 to 22 years. This seven year extension would have a significant adverse impact on the benefits of IDB financing. Such a proposal would be contrary to Congressional intent to provide a public service benefit in the local furnishing of electricity and gas.

SDG&E's IDB PROGRAM

The principal advantage of IDB financing to SDG&E is the ability to raise money indirectly through the issuance of tax-exempt securities at an interest rate which is lower than that available through conventional financing. In this type of financing arrangement, IDB's are issued by a county, city, authority, or other political subdivision with the proceeds used to acquire, improve or construct facilities for use by SDG&E.

The City of San Diego and the California Public Utilities Commission have approved IDB financing for SDG&E in the amount of $300 million, a portion of which is currently in the process of issuance. The remainder is expected to be issued within twelve months. Serving San Diego County and a portion of Orange County, SDG&E qualifies for IDB financing for the "local furnishing of electricity and gas" under the two-county rule.

SDG&E is utilizing IDB financing to alleviate electric and gas rates which are among the highest in the nation. High rates in some regions of the country have resulted from a fuel mix which has been unusually sensitive to external political influences, such as 1973 oil embargo. It is estimated that SDG&E's projected IDB financing will save customers approximately $300 million over the thirty-five year life of the bonds. This benefit to SDG&E's customers is even greater since the Company delayed much of its long-term debt financing planned for 1982, to take advantage of IDB financing.

The proceeds of the IDB's will be utilized to finance projects which involve the acquisition, construction, and installation of certain facilities for the generation and transmission of electric energy and the distribution of electric energy and gas, including major new electric energy supply transmission facilities which are part of a two county system, as well as necessary additions and improvements to existing electric transmission facilities at various locations in San Diego and Orange Counties, electric generation facilities at various sites in San Diego County, and electric and gas distribution facilities located throughout the electric and gas service areas in San Diego and Orange Counties.

EXISTING IDB PROVISIONS SHOULD BE PRESERVED

There are several reasons why the continued availability of IDB financing for the local furnishing of electricity and gas is in the public interest.

Such financing serves the public interest much the same as essential public projects traditionally financed by public agencies. They differ from private IDB financing which may benefit only a limited community, i.e., shareholders and employees of the business involved. In contrast, benefits derived from IDB financing for local furnishing are passed through to the utility customer. Lower debt costs to the utility translate into lower rates to the utility customer.

The anticipated volume of IDB financing for the local furnishing of electricity and gas is not expected to be great. Based upon available figures, it is estimated that a maximum of $1.3 billion in IDBs for local furnishing of electricity and gas will be issued through 1986, because there are a very limited number of utilities who are eligible under the two-county rule. Therefore, the revenue loss to the federal government should not be substantial. In the case of SDG&E, it is only $26.9 million.

Any changes to IDB financing must be viewed in light of the fact that there have been several changes in the tax law which have been disadvantageous to public utilities. For example, TEFRA removed the repair allowance, imposed capitalization of interest and taxes during construction, and reduced the depreciable basis of assets by one-half of the investment tax credits.

Additional restrictions will only further increase the cost burden on energy consumers.

CONCLUSION

In closing, the IDB financing for the local furnishing of electricity and gas provides benefits is in the broad public interest because:

1. It mitigates regional disparity in rates.

2. It removes inequities which exist between consumers of municipal and private utilities.

3. It supports facilities which provide a level of reliability benefiting broad areas of the country.

4. It mitigates the effect of other recent tax restrictions which tend to increase the cost burden on energy consumers.

Mr. PICKLE. Thank you, sir.

And now, Mr. Eugene P. Waters.

STATEMENT OF EUGENE P. WATERS, SENIOR VICE PRESIDENT, FINANCE, AND TREASURER, NEW YORK STATE ELECTRIC & GAS CORP.

Mr. WATERS. Yes, sir, Mr. Chairman.

I would like to thank you for the opportunity to testify before you today.

I will address the use of tax-exempt bonds to finance pollution control facilities and the related depreciation of such facilities.

I am Eugene Waters, senior vice president of finance and treasurer of New York State Electric & Gas Corp., which is an investor-owned electic and gas utility serving about 35 percent of the area of upstate New York. We serve about 678,000 electric customers and 130,000 gas customers, and generate annual revenues of about $887 million, which is 80 percent from electric, and have assets of about $3 billion.

Our company is in the process of building a wholly owned coal-fired generating station on Lake Ontario which will produce 625 megawatts of electricity, and we are also 18-percent coowners in the construction of the Nine Mile Point Unit No. 2 nuclear generating station in Oswego, N.Y. Our portion of the costs for these construction projects is estimated to total $1.8 billion and the stations are now both about 50-percent complete.

This new generation is needed in New York to satisfy future load growth, replace lost hydroelectric energy from the power authority of the State of New York, and to displace expensive oil-fired generation. Completion of these facilities will contribute to the national goal of achieving independence from foreign oil and will provide new energy sources to aid economic recovery and prosperity.

As an integral part of these significant construction activities, we are required by law to install expensive pollution control equipment to protect the public from potentially polluting effects of our plant operations.

Pollution control equipment does not add energy output to the stations and, in fact, decreases their productive efficiency. Although they provide additional protection for all citizens, the beneficiaries are not necessarily all ratepayers of our company.

We anticipate that about $300 million will be expended on pollution control abatement facilities for our stations under construction. Of this amount, $265 million will be expended for our coal-fired plant and will comprise one-quarter of the total cost of that facility.

Included in the 1982 tax bill, now known as TEFRA, were proposals to severely restrict the use of tax-exempt bonds for the financing of pollution control facilities. As a result of the transition rule under section 216 of TEFRA, we can still issue these bonds and utilize accelerated depreciation to finance pollution control facilities at our plants which were under construction prior to July 1, 1982.

If H.R. 1635 were enacted as written, thereby repealing the transition rule under section 216, our pollution control facilities under construction would retroactively be subject to its provisions, and therefore, the cost to the company and our ratepayers would be about $15 million over the next 3 years.

While we recognize and are committed to the public responsibility of a cleaner environment, we request that you also recognize the responsibility to help us keep the public's rates as low as possible for the energy our country needs and demands. Electric utilities must continue to be allowed the use of these bonds in addition to accelerated depreciation and shortened depreciable lives for the express purpose of constructing pollution control facilities.

Our company, and indeed, the electric utility industry as a whole, has substantial investments in pollution control facilities. The use of tax-exempt pollution control bonds and the liberalized depreciation deductions have been essential to the financing of these investments. Considering the troubled financial condition of the electric utility industry, and because pollution control facilities benefit the public while providing no operational benefit to utilities or ratepayers, we regard the ability to raise relatively lower cost capital and recovery of our investment through accelerated depreciation as essential.

We feel that this important form of financing represents a unique partnership between the Federal Government and the electric utilities which was designed to meet the very expensive requirements of an equally important public policy. At the same time, we recognize that Congress must raise additional revenues and cut spending to reduce the Federal budget deficits.

However, we urge you not to make changes in the tax laws that will further weaken the financial condition of our company and place an additional burden on our ratepayers. The proposed changes would have a direct negative impact on earnings during the heaviest construction period of our history. The significant expenditures by our company and its ratepayers toward the goal of pollution abatement will benefit society. Thus, pollution control facilities should be entitled to the benefits of accelerated depreciation and shortened depreciable lives in addition to tax-exempt funding.

Mr. Chairman, in addition, one of our primary concerns with H.R. 1635, as we read it, is that enactment would retroactively repeal the exemption in TEFRA which allowed facilities under construction but not necessarily in service on or before July 1, 1982, to have the benefits of tax-exempt financing and accelerated depreciation.

I thank you, sir.

[The prepared statement follows:]

STATEMENT OF EUGENE P. WATERS, SENIOR VICE PRESIDENT—FINANCE AND TREASURER, NEW YORK STATE ELECTRIC & GAS CORP.

First of all, I would like to thank Chairman Rostenkowski and the Committee for the opportunity to testify before you today. I will address the use of tax-exempt bonds to finance pollution control facilities and the related depreciation of such facilities.

My name is Eugene P. Waters and I am Senior Vice President-Finance and Treasurer of New York State Electric and Gas Corporation, an investor owned electric and gas utility serving about 35% of the area of New York State. We serve about 678,000 electric customers and 130,000 gas customers in the Southern Tier and certain parts of Northern and Western New York State. We generate annual revenues of about $887 million (80% from electric) and have total assets of about $3 billion.

Our Company is in the process of building a wholly owned coal-fired generating station, known as Somerset, on Lake Ontario which will produce 625 mw of electricity and are also 18% co-owners in the construction of the Nine Mile Point Unit No. 2 Nuclear generating station in Oswego, New York. Our portion of the costs for these construction projects are estimated to total $1.8 billion and the stations are both over 50% complete. This new generation is needed in New York to satisfy future load growth, replace lost hydroelectric energy from the Power Authority of New York and to displace expensive oil fired generation. Completion of these facilities will contribute to the national goal of achieving independence from foreign oil and will provide new energy sources to aid economic recovery and prosperity.

As an integral part of these significant construction activities, we are required by law to install expensive pollution control equipment to protect the public from potentially polluting effects of our plant operations.

Pollution control equipment does not add energy output to the stations and, in fact, decreases their productive efficiency by about 2%. Although they provide additional protection for all citizens, the beneficiaries are not necessarily ratepayers of our Company.

We anticipate that about $300 million will be expended on pollution control abatement facilities for our stations under construction. Of this amount, about $265 million will be expended for our coal-fired plant and will comprise one quarter of its total costs. In addition, we are making other expenditures throughout our service area designed to protect and enhance the environment. Congress, recognizing the financial burden of constructing pollution control facilities, provided certain tax incentives which enable us to finance such facilities through the use of lower cost tax-exempt pollution control bonds.

Included in the 1982 tax bill now known as TEFRA, were proposals to severely restrict the use of tax-exempt bonds for the financing of pollution control facilities. As a result of the transition rule under § 216 of TEFRA we can still issue these bonds and utilize accelerated depreciation to finance pollution control facilities at our plants which were under construction prior to July 1, 1982. Without this rule, the Company and its ratepayers would have been faced with additional costs of $9 million in 1984, 1985 and 1986 alone. If H.R. 1635 were enacted as written, thereby repealing the transition rule under § 216, our pollution control facilities under construction would be subject to its provisions, and therefore the cost to the Company and our ratepayers would be about $15 million over the next three years. While we all recognize and are committed to the public responsibility of a cleaner environment, we request that you also recognize the responsibility to help us keep the public's rates as low as possible for the energy our country needs and demands. Electric utilities must continue to be allowed the use of these bonds in addition to accelerated depreciation and shortened depreciable lives for the express purpose of constructing pollution control facilities.

Our Company, and indeed the electric utility industry as a whole, has substantial investments in pollution control facilities. The use of tax-exempt pollution control bonds and the liberalized depreciation deductions have been essential to the financing of these investments. Considering the troubled financial condition of the electric utility industry and because pollution control facilities benefit the public while providing no operational benefit to utilities or ratepayers, we regard the ability to raise relatively lower cost capital and recovery of our investment through accelerated depreciation as essential.

We feel that this important form of financing represents a unique partnership between the federal government and the electric utilities which was designed to meet the very expensive requirements of an equally important public policy. At the same time, we recognize that Congress must raise additional revenues and cut spending to reduce the federal budget deficits. However, we urge you not to make changes in the tax law that will further weaken the financial condition of our Company and place an additional burden on our ratepayers. The proposed changes would have a direct negative impact on earnings during the heaviest construction period of our history. The significant expenditures made by our Company and its ratepayers toward the goal of pollution abatement will benefit society, thus pollution control facilities should be entitled to the benefits of accelerated depreciation and shortened depreciable lives in addition to tax-exempt funding.

Mr. Chairman, I would be pleased to answer any questions you or any of the members may have. Thank you.

Mr. PICKLE. Thank you, Mr. Waters.

Now, Mr. Richard Mannix, senior legislative representative of the Brooklyn Union Gas Company.

STATEMENT OF RICHARD J. MANNIX, SENIOR LEGISLATIVE REPRESENTATIVE, BROOKLYN UNION GAS CO., ACCOMPANIED BY HAROLD J. HELTZER, ESQ., TAX COUNSEL, ON BEHALF OF FRED J. GENTILE

Mr. MANNIX. Thank you, Mr. Chairman.

My name is Richard Mannix, and with me is Mr. Harold Heltzer, our tax counsel. We appear today in place of Mr. Fred Gentile, the vice president and chief accounting officer, who has asked us to convey his apologies for being unable to attend.

Brooklyn Union provides natural gas service to approximately 4 million gas consumers in the New York City boroughs of Brooklyn, Queens, and Staten Island. Ninety-seven percent of these consumers are residential users of gas. A very large percentage of them are dependent upon some form of fixed income.

I would like to direct my testimony to one particular provision of H.R. 1635. Of paramount concern to public utilities is the provision which would require the cost of certain public utility facilities financed through the issuance of industrial develoipmnent bonds to be recovered over a period of 22 years rather than over their current ACRS life of 15 years.

Brooklyn Union Gas opposes this provision of the bill because it would inhibit realization by our customers of the full potential of Brooklyn Union's use of industrial development bonds to provide facilities for the local furnishing of gas.

We believe that the extent to which public utilities differ from other users of industrial development bonds is not fully appreciated. There are several fundamental distinctions between regulated public utilities and other industrial development bond users which should persuade Congress to preserve the current treatment of IDB's for utilities.

The first of these distinctions is that in the case of a public utility, the proceeds of the bonds are used exclusively for public purposes. Most industrial development bonds are used for the purpose implied by their name, to develop private industry in the issuing locality. Often, the only effect of the bonds is to cause a factory, perhaps, which would have been built in any event, to locate in the issuing locality rather than elsewhere.

In contrast, the bonds issued for the local furnishing of gas or electric are issued exclusively for public purposes. These bonds enable a utility to provide fundamental services to residents of the locality. Brooklyn Union will use the proceeds from the sale of these bonds to finance various projects for the local furnishing of gas such as the installation of gas distribution mains and service lines, replacement and modernization of gas meters and regulators, improvement and enhancements to certain gas production and storage facilities, and to assist us in projects to extract methane from the city's landfills.

The second distinction we would like to make on behalf of public utilities is that there is no double dip for public utilities from

ACRS and industrial development bond use. Much of the impetus behind extending the ACRS, the lives under ACRS over which property financed with industrial development bonds may be recovered, is the belief that taxpayers utilizing both ACRS and IDBs receive a double dip. Regulated public utilities do not enjoy this double dip because they are rate regulated and limited to a reasonable rate of return. Additional savings provided by ACRS and industrial development bonds are passed along to consumers in the form of lower rates. It is the consumer and not the utility who ultimately benefits from reduced costs involved.

The situation is different for a nonregulated company which may use the savings in any manner it wishes.

The third of the distinctions we would like to make is that in the use of IDB's by public utilities, there is less potential for revenue loss because of the normalization method of accounting.

Another reason for lengthening the cost recovery period for property financed with industrial development bonds may be the perception that too rapid a revenue loss is involved. Regulated public utilities differ from all other taxpayers in that to obtain the benefits of ACRS, they must use the normalization method of accounting. This prevents an immediate drop in rates to reflect the full tax benefits of ACRS. It avoids a precipitous drop in rates as well as a drop in tax revenues. Eventually the full savings from ACRS and industrial development bonds will be passed on to the consumers, but in an orderly fashion which does not choke off the Treasury's revenue flow in early years.

Mr. Chairman, in view of these considerations, Brooklyn Union strenuously urges that this committee not take action which would further limit, in the case of regulated public utilities, the benefits of ACRS and industrial development bonds.

We have submitted a written statement which we ask be incorporated into the record, and thank you very much for giving us this opportunity to present our views.

[The prepared statement of Mr. Gentile follows:]

STATEMENT OF FRED J. GENTILE, VICE PRESIDENT AND CHIEF ACCOUNTING OFFICER OF THE BROOKLYN UNION GAS CO.

Mr. Chairman and members of the Committee:

My name is Fred Gentile. I am Vice President and Chief Accounting Officer of The Brooklyn Union Gas Company. I would like to thank you and the other members of the Committee for affording me the opportunity to testify here today. Accompanying me is our outside tax counsel, Harold J. Heltzer, Esquire. Brooklyn Union provides gas service to approximately four million gas consumers in the New York City boroughs of Brooklyn, Staten Island and part of Queens. Ninety-seven percent of these consumers are residential users.

I would like to direct my testimony to certain provisions of H.R. 1635. That bill would impose a variety of limitations on the use of industrial development bonds, particularly small issues. Of paramount importance to public utilities, however, is a provision which would require the cost of certain public utility facilities financed through the issuance of industrial development bonds to be recovered over a period of 22 years, rather than over their current Accelerated Cost Recovery System ("ACRS") lives of 15 years.

Brooklyn Union Gas opposes this provision of the bill because it would inhibit the ability of Brooklyn Union's customers to realize the full potential of our company's use of industrial development bonds to provide facilities for the local furnishing of gas.

I. Introduction

We believe that the extent to which public utilities differ from other users of industrial development bonds is not fully appreciated. Indeed, public utilities were, like other users, made subject to the full range of restrictions on industrial development bonds which were imposed by the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"). There are, I believe, three fundamental distinctions between regulated public utilities and other industrial development bond users which should lead the Congress to preserve the current treatment of industrial development bonds for such utilities, regardless of what action Congress may take with regard to other users. These differences are:

- Proceeds of the Bonds Are Used for Exclusively Public Purposes.

Most "industrial development" bonds are used for the purpose implied by their name -- to develop private industry in the issuing locality. Often the only effect of the bonds is to cause a factory, which would have been built in any event, to locate in the issuing locality rather than elsewhere. The private business benefited by the bonds may have no connection with the issuing locality, other than to employ residents and pay taxes. The locality derives only these indirect benefits from issuing the bonds.

In contrast, the bonds issued to benefit regulated public utilities are issued exclusively for public purposes. These bonds, which may be issued for the local furnishing of gas and electricity, enable the utility to provide fundamental services exclusively to residents of the locality. In the language of the Press Release announcing these Hearings, these purposes are like the "traditional public purpose projects" for which tax-exempt bonds are properly issued, rather than use "in the trade or business of a private firm."

- There Is No "Double Dip" for Public Utilities from ACRS and Industrial Development Bonds.

Much of the impetus behind extending the lives over which property financed with industrial development bonds may be recovered under ACRS is the belief that taxpayers utilizing both receive a "double dip." This was also one of the apparent reasons behind the TEFRA amendments requiring the cost of such property to be recovered using the straight-line, rather than a declining balance, method.

Regulated public utilities do not enjoy this double dip because they are rate regulated and limited to a reasonable rate of return. Additional savings provided by ACRS and industrial development bonds are passed along to consumers in the form of lower rates. It is the consumer, not the utility, who ultimately benefits from the reduced costs involved.

- There Is Less Revenue Loss Because of the Normalization Method of Accounting.

Another reason for lengthening the cost recovery period for property financed with industrial development bonds may be the perception that too rapid a revenue loss is involved. Under ACRS, large deductions are available in the early years after property has been placed in service. If competitive factors forced a taxpayer to pass through the benefits of these deductions immediately in the form of reduced prices, a further drop in the taxable income of that taxpayer could result.

Regulated public utilities differ from all other taxpayers in that, to obtain the benefits of ACRS, they must use the "normalization" method of accounting. Under this method, the benefits of ACRS are not taken into account immediately but are spread over the useful life of the asset in determining the tax expense for the utility and, hence, what its rates should be. This prevents an immediate drop in rates to reflect the full tax benefits of ACRS and thus avoids a precipitous drop in rates as well as tax revenues. Eventually, as noted above, the full savings from ACRS and industrial development bonds will be passed on to consumers, but in an orderly fashion which does not choke off the Treasury's revenue flow in early years.

Mr. Chairman, I would like to elaborate on these three points, and in addition describe other reasons why regulated public utilities differ from other users of industrial development bonds.

II. Public Purpose

I believe the best example I could give of the public use to which regulated public utilities put industrial development bonds would be to explain how Brooklyn Union Gas currently plans to use bonds which would be issued under the exemption for facilities to provide local furnishing of gas energy.

Brooklyn Union has filed an application with the New York State Energy Research and Development Authority for the issuance of up to 175 million dollars of tax-exempt bonds for the local furnishing of gas energy. Brooklyn Union Gas will use the proceeds from the sale of these bonds to finance various projects for the local furnishing of gas energy which include installation of gas distribution mains and service lines; replacement and modernization of gas meters and regulators; improvements and enhancements to certain gas production and storage facilities; and extraction of methane from landfill areas. These projects will provide improved and expanded gas service to the approximately four million people in Brooklyn, Queens and Staten Island who use gas.

o The Benefits of Natural Gas.

Use of tax-exempt bonds for Brooklyn Union's gas service system will result in increased availability and more efficient use of gas energy to consumers within our service territory. Wider use of gas within Brooklyn Union's territory is both consistent with the New York State Energy Master Plan, and helpful in the nation's efforts to reduce oil imports. In addition, expansion and improvement of projects to extract gas from landfills will provide New York with an indigenous energy source.

- Environmental and Safety Benefits.

Additions and improvements to our gas distribution system, financed by the bonds, will assure Brooklyn Union customers of a safe, clean, efficiently delivered supply of natural gas. The proposed capital projects will also upgrade and replace old cast iron mains, some of which have been in service since the late 19th century. By improving its production and storage facilities, Brooklyn Union will be able to provide substantially more peak level service to all residents even on the coldest winter days.

Improvements in our distribution infrastructure will enable Brooklyn Union to expand gas facilities to new homes, as well as new commercial and industrial establishments. Expansion of our distribution system will permit the addition of more heating customers, thereby reducing dependence on imported oil while at the same time reducing air pollution in New York City. Over the next three years, Brooklyn Union marketing objectives include the displacement of 66 million gallons of fuel oil, thereby reducing sulphur dioxide emissions by 2,800 tons and particulate matter by approximately 915,000 pounds during that period. Expansion of the distribution system will also spread fixed costs over more customers, which tends to minimize the need for future rate increases. Qualitative improvements will increase the efficiency of our distribution system, and help to reduce the cost of service to our ratepayers.

The landfill projects will extract gas from refuse and utilize a previously untapped energy resource within New York City. Currently, methane gas from the landfills is emitted into the atmosphere, creating an unpleasant odor. The Company's landfill projects not only make more clean energy available to its customers but also will result in less gas escaping into the atmosphere. In addition, it is estimated that the City of New York will receive royalty payments of about one million dollars per year over the life of the landfill projects.

- Benefits of Revenue Bonds for Brooklyn Union Customers.

Use of industrial development bonds will produce significant benefits for Brooklyn Union's customers. The tax-exempt feature will allow Brooklyn Union to market these bonds at approximately three percentage points below the interest cost for comparable taxable debt issues. Over the thirty-year period of the proposed financing, this will result in a savings of 157 million dollars in financing costs which will be passed entirely to our customers through the rate structure. Currently over 95% of the residents in the Company's service area use gas for cooking. Over 66% of the homes and 21% of the apartment houses use gas for heating. Use of tax-exempt financing will, therefore, have a far-reaching and favorable impact on the residents of Brooklyn, Queens, and Staten Island, many of whom are on fixed income. In fact, the predominant number of our customers are either low income or low middle income or senior citizens on fixed income.

Further, reduced borrowing costs will improve the Company's interest coverage ratios, which in turn will reduce the cost of any future conventional debt borrowed for capital projects. The lower cost of borrowing will also strengthen the Company's debt rating, which is an important consideration in pricing public debt issues. These savings, again, will benefit the Company's ratepayers.

In summary, the use of tax-exempt bonds for the local furnishing of gas energy will have a substantial and beneficial impact by passing savings in energy costs directly to our customers. In addition it will improve the environmental and economic well being of the City of New York. Also, in accordance with the New York State Energy Master Plan, the Company's capital projects will substantially reduce oil imports, develop indigenous sources of energy supply, and foster use of more efficient gas appliances to conserve energy. However, all of these benefits would be reduced to the extent that the benefits from use of industrial development bonds are offset by reduced ACRS benefits.

III. No "Double Dip"

Regulated utilities are generally required to pass through the benefit of accelerated cost recovery deductions to their customers under a "normalization" method of accounting pursuant to which depreciation is allowed as an expense only ratably over the life of an asset and the income tax reduction brought about through ACRS is also taken into account ratably for rate-making purposes. Over the life of the asset, the utility will be required by its regulators to flow through the entire benefit of ACRS to customers in the form of reduced rates. Moreover, the utility's reduced financing costs through the use of industrial development bonds will also be passed on to customers. Thus, the "double dip" (enjoyment of both ACRS and industrial development bond tax benefits) simply does not exist for regulated utilities. Because such companies are limited to a reasonable rate of return on investment, they cannot realize the benefits of ACRS in the same manner as an unregulated company, which potentially can keep the entire extra after-tax profits resulting from ACRS and industrial development bonds.

Because the increased capital pool and reduced financing costs resulting from ACRS and industrial development bonds will reduce the cost of new facilities, regulated utilities will not be required to charge greatly increased rates (which, because they would be offset by increased costs, would not result in increased income tax revenues from utilities) to industrial users of energy and other utility services. As a result, the costs of these users would be kept under control, relieving inflationary pressures on the prices the users must charge their customers. (Moreover, if the utility users could not, because of the current economic climate, pass costs along to customers, increased utility prices would result in decreased taxable income to them and a revenue loss to Treasury. Keeping utility costs under control would avert this loss.)

Because energy costs are a major industrial expense, keeping energy costs under control through reduced utility capital costs will be important in taking the country out of the recent recession.

Non-business users of utilities would also benefit from stabilization of utility costs. Sharp increases in such costs often can be absorbed by the wealthy but can have a devastating effect on the poor and the elderly.

IV. Normalization Accounting

While ACRS could result in significant revenue loss from unregulated companies, the normalization method of accounting for ACRS prevents the same result in the case of a regulated utility. An unregulated company might be forced by intense competition to pass on the entire benefit of ACRS and industrial development bonds to customers immediately through lower prices, reducing its taxable income. Regulators cannot require that the reduced income tax expense resulting from ACRS be flowed through immediately to customers of a regulated utility in the form of lower rates. Thus, revenues of the regulated utility are not reduced immediately through the rate-making process and the utility continues to pay significant income tax on the revenues it is permitted to collect.

This may be illustrated by the example in Table 1. The first set of figures shows the result which would ensue if the entire benefit of ACRS were flowed through immediately to customers. Assuming that the utility's regulators determine that an after-tax return on investment of $200 is allowable, the utility will be permitted to collect only $1,000 in revenues and will pay current Federal income tax of $200. The second column shows the result of normalization accounting. The utility is permitted to charge

$1,100 and pays current Federal income tax of $250. (An additional $50 is deducted from current book revenue and held in a reserve to permit the utility to pay Federal taxes greater than those taken into account under normalization in later years.)

Table 1

	Flow-Through	Normalization
Revenues	$1,000	$1,100 (1)
Expenses (before Federal income tax) per books	500	500
	$ 500	$ 600
Excess of ACRS deduction over book depreciation	100	100
Taxable Income	$ 400	$ 500
Federal Income Tax at 50%	$ 200	$ 250
Deferral of Federal income tax benefit resulting from excess of ACRS over book depreciation. $100 at 50%		$ 50
Total Federal Income Tax	$ 200	$ 300
Net Income after Tax	$ 200	$ 200

V. Additional Factors

There are two additional factors which I feel must be mentioned in this context.

- Utility Capital Formation Will Be Assisted.

Studies have shown that regulated utilities are likely to be significantly undercapitalized in the coming decades. The availability of ACRS will allow regulated utilities to generate internally temporary pools of capital to assist in expanding their facilities. Under normalization, the regulated utility has temporary use of the tax savings from ACRS, but ultimately these savings are taken into account in determining a reasonable rate of return. The availability of industrial development bonds will help to assure that financing can be obtained at reasonable interest rates.

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(1) The additional revenue requirement of $100 is determined by allowing $2 of revenue to recover $1 of cost and allowing for an income tax rate of 50%. In the example, $100 of revenue was required to recover the $50 of deferred Federal income tax.

While regulated utilities generally are permitted to earn a "reasonable" return, the rate-making process prevents the utilities from earning a return which is higher than "reasonable." Because of this limitation, regulated utilities have been losing their competition with nonregulated businesses to attract equity capital, since there is no possibility that the investor will receive a high return on investment, a possibility offered by nonregulated companies competing for capital. To be put on a par with nonregulated businesses in capital development, regulated utilities need the temporary capital pool provided by ACRS under normalization accounting and the low financing costs afforded by industrial development bonds.

o Advancement of National Energy and Environmental Policy.

The added capital made available by ACRS and industrial development bonds will permit more rapid modernization of facilities, promoting energy conservation, use of alternative energy sources, lessened dependence on oil imports, and fewer pollutants, as is illustrated by Brooklyn Union's proposed use of such bonds discussed earlier.

VI. Conclusion

Mr. Chairman, industrial development bonds issued on behalf of regulated public utilities undeniably serve public, rather than private, purposes. They are clearly different in this regard from other industrial development bonds which may benefit only private industry. Utility bonds are used to provide fundamental public services to the residents of the issuing localities.

The utilities themselves do not profit from the tax advantages of ACRS and industrial development bonds. Utility profits are limited by regulation to a reasonable rate of return on investment. The savings resulting from use of ACRS and industrial development bonds are realized entirely by the utility consumers. In Brooklyn Union's case, these are predominantly low income, low middle income, and elderly individuals.

The combined use by regulated public utilities of ACRS and industrial development bonds does not pose the same threat to Treasury revenues as such use by other taxpayers. Under the normalization method of accounting, utilities are able to maintain their rates and not cut them sharply in the early years of cost recovery, as could be the case for an unregulated company forced by competition to pass through the full benefit of tax reduction to its customers immediately in the form of lower prices. Hence, a regulated utility continues to pay higher tax.

Finally, combined use of ACRS and industrial development bonds is critical to enabling regulated utilities to compete successfully for badly-needed capital. These tax benefits also serve an important role in helping regulated utilities to develop the capital necessary to further National energy and environmental policies.

Mr. Chairman, as a result of these considerations, Brooklyn Union Gas strenuously urges that this Committee not take action which would further limit, in the case of regulated public utilities, the benefits of ACRS and industrial development bonds for the general public.

Mr. PICKLE. Your statement will be included.

Now we have Mr. Warren Preeshl, who is senior vice president of Miller & Schroeder Municipals.

I talked to Mr. Preeshl this morning, and he reminded me he was going to testify today, and I said when, and he said, I think I will be last.

So, Mr. Preeshl, you are last. Somebody has to be, but we appreciate your indulgence, and the rest of the members, for waiting so long to submit your testimony. But we have had a full day.

Mr. Preeshl, if you will proceed.

STATEMENT OF WARREN PREESHL, SENIOR VICE PRESIDENT, MILLER & SCHROEDER MUNICIPALS, INC.

Mr. PREESHL. Thank you, Mr. Chairman.

With your permission, I will highlight my written testimony in the interests of time.

Miller & Schroeder Municipals is solely an underwriter of municipal bonds. We do not handle stocks, corporate bonds, just municipal bonds. We specialize particularly in hospital bonds, tax allocation bonds and industrial revenue bonds. Depending on the month and so forth, we are somewhere between 15th and 30th in the country in revenue bond activities.

With regard to industrial revenue bonds, the two factors that are involved nowadays are, one, the interest rate is lower because of the tax exemption, and two, for small companies, they are the only way I know of for them to get 30-years fixed rate financing. Other financing terms available are take a look at the interest rate in 5 years or 10 years. This is a way for small companies to get long term financing.

It is important to realize that when an interest rate that a company pays is decreased, about 46 percent of that benefit immediately flows to the U.S. Treasury because of the reduction in the interest deduction. So half the benefit of industrial revenue bonds is immediately passed on to the U.S. Treasury, and to some extent, the State tax departments.

One of the suggestions is that if people did not buy tax-exempt bonds, they would buy taxable bonds and pay taxes. It is important to realize that many, many investors in taxable bonds are in themselves tax-exempt. They are pension funds, profit sharing funds, State land local governments, IRA accounts and so forth. My appendix A analyzes what might happen as industrial revenue bonds are shifted into the taxable market, and it indicates that at the 10-percent tax bracket the effect is neutral. If the purchaser of an otherwise tax-exempt industrial bond is someone who does not pay any taxes at all, there is a cost to the Treasury of not allowing the use of industrial revenue bonds. It is not at all certain that industrial revenue bonds cost the Treasury any money at all.

Turning now——

Mr. PICKLE. Mr. Preeshl, let me interrupt you since you are the last witness.

You say that there is no evidence to show that these industrial revenue bonds do cost the Treasury. We have testimony today from Treasury, from the Congressional Budget Office, from the GAO and one other entity, all pointing to the billions of dollars of lost revenue that we suffer in the Treasury because of IDB's.

Now you say it does not cost us anything.

Who are we, the committee, going to believe? Whose facts and figures are we going to take, yours? Should we?

Mr. PREESHL. Not necessarily. It is all a conjecture as to what tax bracket the alternate investor is in. If the alternate investor is not paying any income taxes at all—and most life insurance companies now, most banks, pension funds, profit sharing funds, none of those people pay income taxes of any significant amount, and therefore, the Treasury calculations which are based on the fact that the tax rate is about 30 percent—and that is how they get their figures—I think are overstating the type of people that buy taxable debt.

Mr. CONABLE. That is a pretty interesting point, Mr. Chairman. I think that we ought to speculate a little bit about that. We do make assumptions as to who is buying these taxables and tax-exempts. I want to tell you, banks are buying a large part of the tax-exempts. Of course, that is one of the reasons they do not pay much tax, but the bank is practically a nontaxable entity at this point.

Mr. PICKLE. Yes, the banks. All the law will permit them, they would buy just as fast as they can. They gobble them up, and then they tell us it is really not a very good practice, and if it was not allowed we would not be participating in it and there ought to be a stop put to it. They tell us that in the privacy of our conversations.

But any bank I know of buys all they can get. And you make a point, and Mr. Conable is right about it, that does not make it correct, that does not make it right.

Mr. CONABLE. I think you should look into what is happening lately, the extent to which households have been picking up tax-exempts through the investment trusts. Of course, investment trusts, that is a special tax entity, too. But in fact, that is an indirect ownership by taxable people of tax-exempts.

Historically, they shift back and forth. If the banks start making money again, you can be sure they will go back into tax-exempts with a vengeance. But right now they are not having to buy as many tax-exempts because they have a lot of bad debts. They are heavily in the leasing business. They are using ACRS for all it is worth, and so forth.

It is a complicated area, I will admit that. But you do make a good point.

We had better not shut him off.

Mr. PICKLE. He has taken some of your time, so we will extend your time a little bit longer. Go ahead, sir.

Mr. PREESHL. The second point that I would like to analyze is the general municipal market and what has been happening over the last year or so. Over a longer period of time than that, there has been a tremendous trend toward the issuance of revenue bonds of all kinds by municipalities. That is partly because it is getting more difficult to issue general obligation bonds because of limitations. It is more difficult to get voters to approve them.

So revenue bonds of all kinds are being considered. The general level of interest rates has come down for all municipal bonds about 4 percent in the last 9 months. I have appendix B which shows what the interest rates have been. Interest rates have been coming down.

Even more important, the ratio between municipal bond rates and U.S. Government rates has been dropping. The high that we have seen is municipal rates were about 80 percent. Thank goodness, they are back down to the more normal 70 percent, which indicates to my mind it takes about a 30-percent tax bracket to fully clear the municipal bond market.

Back when I started in the municipal bond business, municipal rates and Government rates were almost the same. They were both about 4 percent.

The other point that I would like to make is that industrial revenue bonds as a small class of private purpose bonds are a relatively small part of the entire municipal market. In the first quarter of 1982, they were 5 percent of the municipal market. In the first quarter of 1983, they were 1.8 percent of the publicly offered bonds. Through the first 5 months of 1983, the new figures are 2.93 percent. They are a small part of the total.

For the first 5 months of 1983, electric and gas were 16 percent of the total municipal market. Housing was 13.2 percent. So the industrial revenue bonds in themselves are a relatively small part.

Now, in the past a lot of tax-exempt mortgages were purchased by life insurance companies, and that buyin has practically stopped. I would predict that the estimate of the CBO for the total industrial bond issuance in 1983, when the final figures are in, you might look at the first 6 months, will be down dramatically from what we are projecting.

I am sorry to see that, because I think industrial revenue bond usage reflects the economy, and the more bonds we can find a company wants, the more jobs are being created.

In conclusion, we support the curtailment of FSLIC. We support the curtailment of sale-leaseback, with some grandfathering.

Mr. PICKLE. You support the curtailment of what?

Mr. PREESHL. Sale and leaseback. That is kind of a Mickey Mouse operation.

We support the limitation on purposes by TEFRA. We worked last year with Representative Frenzel on a $10 million total use by any one company of industrial revenue bonds. So we support the limitation on total use.

We disagree very much on the extension of the depreciable lives, because we think business and industry needs that in order to move ahead and do the things that are necessary in this country to create jobs. And we do not like the limitation on the use of the rehab credit for historical buildings, because we think that is a targeting in itelf. But in general we support the things you are doing.

Thank you.

[The prepared statement follows:]

STATEMENT OF WARREN PREESHL, SENIOR VICE PRESIDENT, MILLER & SCHROEDER MUNICIPALS, INC.

My name is Warren Preeshl, and I am a Vice President of Miller & Schroeder Municipals, Inc. Our firm specializes in underwriting municipal bonds. We have offices in Minneapolis, Minnesota; Solana Beach, California; Naples, Florida; Chicago, Illinois and Carson City, Nevada.

Our principal activities are concentrated on hospital revenue bonds, industrial development bonds and tax allocation bonds. We also actively bid on general obligation bonds and are consultants to many municipalities and agencies in the issuance of their bonds of all kinds.

In our area of specialization, i.e., municipal revenue bonds, we typically rank between 15th and 30th in the nation.

I would like to speak particularly about industrial development bonds (IDB's), with further comments on trends in municipal finance.

As their name implies, IDB's are designed to foster and encourage industrial and commercial development. The two factors that make them attractive, and there are two, are (1) the lower interest rates they provide and (2) the availability of long term, fixed rate financing. The latter otherwise is not generally available to smaller companies and long term, fixed rate financing is very important to them.

In connection with IDB's, it is important to realize that about half (46% federal, and up to 12% state) of the reduction in interest rate they provide is immediately passed on to the Federal and State government in the form of higher corporate income taxes. This happens because interest is a deductible expense and the less the deduction the higher the income taxes paid.

The first effect of IDB's is therefore to increase Federal and State income taxes. This immediate consequence is not always recognized.

It is true, of course, that the recipient of tax-exempt IDB interest does not pay federal income taxes on that interest income.

However, many recipients of "taxable" interest also do not pay federal income taxes on that interest income.

This is so because these investors are in themselves tax-exempt. Pension and profit sharing plans, State and Local governments, charitable foundations and IRA accounts are examples. (Of course, in future years, individual beneficiaries may pay some income taxes on their distributions, but that is a long way off, and the tax rates will presumable be low).

Other recipients of "taxable" interest are somewhat tax-exempt because of their low tax brackets. Individuals with tax-shelters, many banks nowadays, and many corporations, fall into this low tax bracket category.

In other words, tax-exemption can occur either from the interest itself being tax-exempt or from the recipient of the ostensibly taxable interest being tax-exempt.

A detailed analysis of an example is attached as Appedix A.

The conclusion of the detailed analysis is that the restriction, or abolition, of IDB's may very well decrease federal revenues. Higher borrowing costs will result in less income taxes paid, and this may not be offset by higher income tax receipts derived from "taxable" interest.

In times like these, and with not enough time for the TEFRA-required data to come in, we believe it is too soon to consider any major new restrictions on the issuance of IDB's.

However, we have drafted some suggested language that would accommodate central cities by recognizing their special needs, and abilities, should some further restrictions be considered by the Committee before the TEFRA-required data is available.

The next item I would like to discuss is the impact of IDB's on "legitimate" municipal borrowing rates.

It is important to recognize first the massive move towards revenue bonds of all kinds in contrast to "old-fashioned" general obligation bonds (75% versus 25% perhaps).

Revenue bonds for such things as water and sewer systems, mass transit, municipal electric facilities, etc. are used extensively because the revenues are user related. Revenue bonds can be more secure than G. O. bonds since the general tax base is needed to pay for so many things: police, fire, streets, welfare, major improvements, etc. Many states, too (such as California's Proposition 13) make it very difficult to authorize General Obligation bonds. Few voters like to directly vote for higher taxes.

The move towards revenue bonds is therefore understandable and often desireable.

In looking at municipal bond interest rates, (Appendix B charts interest rates and Appendix C shows the historical indices) it is obvious that U. S. Government, Corporate and Municipal rates move pretty much in unison.

Municipal rates, in spite of the volume of municipal bonds of all kinds being issued, have decreased about 4% per annum from their highs (roughly 13-1/2% to 9-1/2% according to the Bond Buyer's Index). In the last several weeks municipal rates have moved up again, following U. S. Government rates. We in the industry hope, and expect, that this is a temporary aberration.

Along with the actual level of interest rates a concern has been the ratio of municipal yields to U. S. government yields. In recent years a 70% ratio has been customary. In the fall of 1981 this ratio rose to about 80%, primarily attributable, I think, to the reduction in the maximum personal income tax rate from 70% to 50%. This 80% ratio continued thru 1982, but has declined during the first part of of 1983 to close to the more traditional 70% ratio. This probably indicates that the total volume of municipal borrowing is not pressing on the demand, thus bringing municipal rates down, in spite of the recent volume.

Appendix D shows this trend and was taken from the May 25, 1983 PSA "Municipal Market Developments."

The same publication shows (and this is Appendix E) the total municipal bond market for the first quarter of 1983, compared with the first quarter of 1982.

To help analyze the impact of some "private purpose" municipal bonds I have selected several "private purpose" categories and calculated their percent of the total.

For 1983 and 1982 these are:

	1983	1982
Electric & Gas	11.3%	15.0%
Housing	14.6%	9.9%
IDB's	1.8%	5.0%

The total dollar volume of IDB's is only one-half of what it was a year ago. (I think this is unfortunate because it means less new business construction - and fewer new jobs.) However, it is obvious that IDB's are a relatively insignificant amount of the total municipal volume. They can't have any appreciable influence on municipal interest rates!

Housing bonds are still a large part, their volume being increased, I suspect, by the advent of the sunset, and also - and this too is good for the economy - by the decline in interest rates making housing somewhat affordable for moderate income homebuyers.

Electric and gas bonds are a large part of the total, down from last year as a percentage, but not in dollar amount, probably because the Washington Public Power Supply System, which has borrowed about $6 billion in the municipal market, is no longer issuing bonds.

In looking at "private purpose" bonds I would urge the Committee to consider whether the large volume of Municipal Power Agency bonds is necessary. The interest rate benefit is diffused so widely as to have little meaning to the average consumer, yet $300,000,000 offerings keep coming to market. Traditional electric and water revenue bonds, issued so municipalities and agencies can supply their own residents with utility services are, of course, very worthwhile.

I have not mentioned pollution control bonds, but they too are another category of "private purpose" bonds whose use should be reviewed.

In conclusion, I think it is too early to consider new limitations on IDB's, since their actual volume for 1983 won't be known for about a year. Unfortunately for economic growth and job creation, I'm afraid they will be down from 1982.

I think as well, that all categories of "private purpose" bonds should be examined, not just IDB's and housing.

With regard to IDB's we do try to be realistic, and we worked with Representative Frenzel on his proposed IDB legislation last year. We presently are having suggested legislation drafted regarding IDB's and their use in central cities. We would be pleased to be of assistance at any time, since we too are concerned with economic development, job creation, the need to rebuild municipal infrastructure and the general health of the entire municipal bond market.

F. Warren Preeshl
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June 14, 1983

APPENDIX A

ALTERNATIVE COST ANALYSIS OF IDB FINANCING

The use of Industrial Development Bonds by a business in financing new construction has certain affects upon the income tax revenues of the Federal Government.

What those affects are depends on some very uncertain assumptions, of which some are described herein.

This analysis deals only with the immediate impact of IDB's on federal income tax revenues. It does not treat job creation, etc. since such affects are based on the "but for" question, i.e. would the facility be built if IDB financing were not available? Concentrating on income tax revenues provides a more certain analysis, perhaps sufficient in itself to demonstrate the usefulness of the national economy of IDB financing.

Several initial assumptions need to be made. They are: the corporate tax bracket is 46%; the individual investor tax bracket is 50%; certain investors are exempt from the federal income tax; the present (12-15-82) taxable interest rate is 14%; and the present tax-exempt interest rate is 11%.

If a company borrows $1,000,000 at 14% to build a facility the initial annual interest cost is $140,000. Since interest is deductible the breakdown is as follows:

After tax cost to the company	(54%)	$75,600
Reduction in income tax, i.e. cost to the Treasury	(46%)	$64,400

If a company borrows $1,000,000 at 11% to build a facility, the annual interest cost is $110,000. Since interest is deductible the breakdown is as follows:

After tax cost to the company	(54%)	$59,400
Reduction in income tax i.e. cost to the Treasury	(46%)	$50,600

The immediate affect of using IDB's is as follows:

Increase in after-tax income to the company becomes of the lower interest expense:

($75,600 - $59,400) $16,200

Increase in tax revenue to the Treasury because of a decreased deduction for interest expense:

($64,400 - $50,600) $13,800

Disregarding the question of who lends the money, it is obvious that a reduction in interest cost benefits both the company and the U. S. Treasury.

The next analysis to be made concerns the source of the borrowed dollars and the amount of income taxes paid on the interest income.

If a lender buys the 11% tax-exempt Industrial Development Bond, the interest is tax-exempt. The company's after-tax revenues increase by $16,200 and the Treasury's tax collections increase by $13,800. Of the total $30,000 of annual interest savings, 54% is kept by the company and 46% is paid to the Treasury. The lender pays no income tax to offset the company deduction.

The question that constantly occurs however, is whether or not Treasury's income tax collections would be greater if IDB's were abolished.

In asking this question, the "but for" question does arise i.e., would the company proceed with the facility if the interest cost were 14%? There is, of course, no simple certain answer. We do know home buyers balk at 14% interest, as do many businesses. The following analysis focuses only on direct income tax consequences arising from the lender's tax bracket.

In analyzing the probable increase in income tax collections from the required use of taxable borrowing (assuming IDB's are abolished), four separate categories of lenders must be considered; a 50% tax bracket; a 30% tax bracket; a 10% tax bracket and a 0% tax bracket.

50% Bracket

If the lender is in the 50% bracket the $140,000 of "taxable" interest income results in a $70,000 increase in income taxes paid.

As shown above, the company has reduced it's income tax payments by $64,400 and the lender has increased it's income tax payments by $70,000. The deduction for interest has been more than offset by the increased income tax paid. This is the best possible result to the Treasury, being a net gain of $5,600! If the lender were in the 46% bracket the result would be a "wash", to the Treasury, with increased interest expense deduction exactly offset by the increase in taxes paid by the lender. The company would, of course have an interest expense, after taxes, that is greater than if it used IDB's.

There is, however, a real world flaw in this analysis. No investor would settle for an after-tax yield of 7% (50% of 14%). General Obligation municipal bonds, pay 10% or so. The hypothetical purchaser of the 14% taxable bonds therefore must be in a lesser tax bracket than 50%.

30% Bracket

If the lender were in the 30% tax bracket (where 14% ≠ 9.80%), the $140,000 of interest income would result in a $42,000 increase in income taxes paid, versus the $64,400 reduction in income taxes because of the $140,000 interest deduction.

This is still better, for the Treasury, than allowing the use of Industrial Development Bonds, since the reduction in taxes paid by the company of $64,400 is partially offset by the $42,000 increase in income tax collections.

10% Bracket

However, some studies indicate that the over-all average tax bracket for purchasers of taxable debt is 10%. This rate presumably melds together the ability of many investors to shelter income, the very low income level of many older investors, the reduced tax bracket (by virtue of losses) of many lenders, and the fully tax-exempt status of many lenders (government funds, pension funds, charitable trusts, endowment funds, IRA and Keogh accounts, etc.).

Accordingly, if the average lender were in the 10% tax bracket, the $140,000 of interest income would result in a $14,000 increase in income taxes versus the $64,400 reduction in income taxes because of the $64,400 deduction.

At this point, the use of taxable bonds or tax-exempt bonds is in balance, that is the abolotion of IDB's would NOT increase Treasury tax collections. The gain to the Treasury from the taxes paid on taxable interest ($14,000) is almost exactly the same as the taxes lost by the increased deduction for interest expense ($13,800). The benefit of reduced interest expense, and thus increased after-tax earnings are still there for the company who is allowed to use tax-exempt IDB's.

Therefore, the availability of IDB's may encourage the company to expand whereas the abolishing of IDB's may inhibit expansion.

0% Bracket

However, the very real possibility exists that the lender is tax-exempt (a pension fund, for example) so that the 14% interest income would be just as "tax-exempt" as the 11% IDB bonds. In this case, the company would have a greater interest expense deduction, with no corresponding enhancement of Treasury tax collections, if IDB's were abolished. The abolition of IDB's would therefore reduce Treasury tax collections.

In conclusion, therefore, it is not certain that the abolition of IDB financing would raise income tax revenues. It is entirely possible, depending on where the alternate financing is borrowed, that the abolition of IDB financing would cost tax revenues. This consideration is separate from the possibility, all too apparent in these times, that the higher interest rate will discourage plant expansion.

To summarize the above discussion, the following table may be helpful.

Distribution of Interest Rate Reduction:

	Taxable Bond	IDB
Interest Expense	$140,000	$110,000
After-Tax Cost to the Company	$ 75,600	$ 59,400
Reduction in Income Taxes Paid	$ 64,400 (1)	$ 50,600 (1)

(1) Note - 46% of any interest rate reduction accrues to Treasury.

The Lender is in the 50% Bracket:

	Taxable Bond	IDB
Increased Income Taxes Paid by a 50% Tax Bracket Investor	$ 70,000	$ -0-
Over-all Treasury Position	$ 5,600 "ahead"	$ 50,600 "behind"

The Lender is in the 30% Bracket:

	Taxable Bond	IDB
Increased Income Taxes Paid by a 30% Tax Bracket Investor	$ 42,000	$ -0-
Over-all Treasury Position	$ 22,400 "behind"	$ 50,600 "behind"

The lender is in the "Average" 10% Bracket:

	Taxable Bond	IDB
Increased Income Taxes Paid by a 10% Tax Bracket Investor	$ 14,000	$ -0-
Over-all Treasury Position	$ 50,400 "behind"	$ 50,600 "behind"

Note: At this point the use of IDB's has no affect on Treasury revenues, assuming the project would go ahead in either case, and thus one or the other interest deduction is taken by the Company.

The Lender is Exempt from Income Taxes:

	Taxable Bond	IDB
Increased Income Taxes Paid by a Tax-Exempt Investor	$ -0-	$ -0-
Over-all Treasury Position	$ 64,400 "behind"	$ 50,600 "behind"

Note: At this point the abolition of IDB financing is costly to the Treasury. This is an important point, since many purchasers of taxable debt are themselves exempt from income taxes.

In general, the "Distribution of Interest Rate Reduction" shows that the interest savings from the use of IDB's is shared with the Treasury on a 46 - 54 split.

The remaining four schedules show that an increase in Federal Income Tax revenues derived from the abolition of IDB's is not a certain outcome. The many investors in "taxable" debt are in themselves essentially exempt from income taxes. The usual "30% tax bracket" assumption is not valid.

The abolition of IDB's may very well decrease revenues, not only because of the increased interest deductions but also because of the danger that industrial and commercial job creation will be impeded. In these times, at least, nothing should be done to impede economic recovery.

F. W. Preeshl
1-10-83

FWP/smb

CreditTables

S&P'S MARKET INDEXES

Weekly Bond Yields (%)

	Taxable Governments					
	Long*	Intermediate**	Short***	Bills	20-yr. Municipals	6-month Municipals
5/25	10.68	10.33	9.73	8.46	9.33	5.00
5/18	10.54	10.11	9.50	8.10	9.18	5.10
5/11	10.24	9.88	9.25	8.14	8.83	4.70
5/4	10.18	9.83	9.21	8.04	8.77	4.70
52 Weeks						
High	14.02	11.24	14.52	13.27	12.62	9.75
Low	10.18	9.83	9.21	7.43	6.72	4.00

Corp. Composite	AAA	AA	A	BBB
5/25	11.21	11.38	11.80	12.07
5/18	11.01	11.17	11.45	12.08
5/11	10.68	10.85	11.11	11.62
5/4	10.62	10.78	11.08	11.58
52 Weeks				
High	14.88	15.24	15.42	17.08
Low	10.62	10.78	11.08	11.58

* 10 or more years average maturity
**6–9 years average maturity
***2–4 years average maturity
†New high or low

Average maturity dates and coupon rates (%)—Industrials October 2002, 8.88; Utilities August 2004, 8.53; Composite September 2003, 8.71

Money Market Rates (%)

	Federal Funds[1]	Treasury Bills[2]		Commercial Paper 30–59 Days[3]	Certificates of Deposits 3 Months[4]	Prime Rate
		3 Months	6 Months			
5/25	8.55	8.49	8.48	8.50	8.65	10.50
5/18	8.55	8.11	8.16	8.38	8.45	10.50
5/11	8.30	7.98	7.97	8.13	8.20	10.50
5/4	8.54	8.01	7.98	8.13	8.25	10.50

1 As computed by S&P. 7-day averages based on closing bid
2 Bid, secondary market
3 Directly placed
4 Newly issued

Corporate Bond Yields (%)

Utilities	AAA	AA	A	BBB
5/25	11.41	11.56	11.10	12.02
5/18	11.15	11.28	11.47	11.84
5/11	10.79	10.96	11.11	11.52
5/4	10.73	10.85	11.10	11.49
52 Weeks High	15.27	15.69	15.65	17.14
Low	10.73	10.85	11.10	11.49

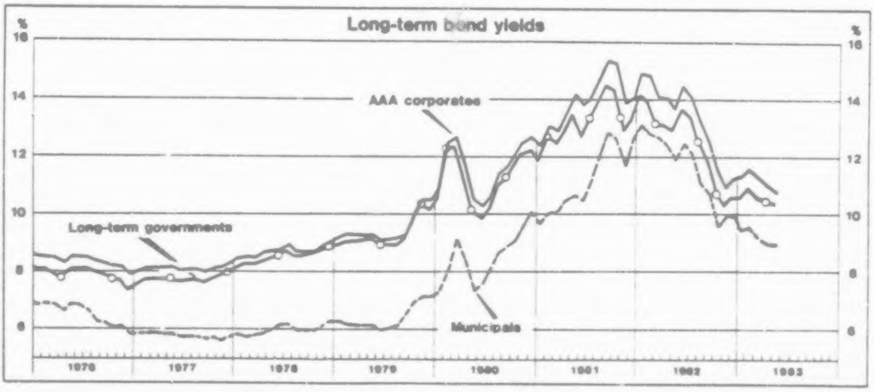
Industrials	AAA	AA	A	BBB
5/25	11.01	11.21	11.52	12.13
5/18	10.86	11.06	11.43	12.31
5/11	10.56	10.74	11.11	11.73
5/4	10.51	10.72	11.07	11.68
52 Weeks High	14.49	14.79	15.19	17.03
Low	10.51	10.72	11.07	11.68

†New high or low

Monetary and Credit Aggregates

Weekly Averages	($ in Billions)		Monetary Base	National C&I Loans	NYC C&I Loans	Money Market Funds	Member Bank Borrowings
	M1	M2*					
5/25	—	—	$183.2	$209.1	$56.1	$170.4	—
5/18	509.2	—	182.9	209.9	56.4	170.4	336
5/11	506.9	—	181.9	211.6	57.1	171.2	464
5/4	499.5	2072	182.5	210.4	56.9	171.6	112
4/27	495.4	—	182.7	211.8	57.8	173.3	334
4/20	494.2	—	180.8	211.4	57.7	175.2	597
4/13	498.1	—	180.8	212.6	58.7	178.3	183
4/6	499.4	2086	179.5	211.6	58.1	180.1	160
Rates of Growth (in %, Annual Rates)							
4 Weeks	17.5	3.1	(11.1)	(9.4)	(27.4)	(58.4)	—
8 Weeks	8.8	7.3	(8.7)	(7.2)	(19.1)	(51.4)	—
13 Weeks	13.5	13.4	(11.9)	(4.0)	(18.6)	(46.5)	—
26 Weeks	13.3	15.3	(9.9)	(1.6)	(11.6)	(46.5)	—
52 Weeks	11.4	12.94	(8.7)	3.9	(0.2)	(11.7)	—

*Monthly average and rate of change of monthly averages



Long-term bond yields

APPENDIX C

DOW - JONES WEEKLY MUNICIPAL AVERAGES

	Week	1978	1979	1980	1981	1982	1983	Week Ending
JAN	1	6.36	7.21	7.63	10.53	14.14	—	7
	2	6.45	7.07	7.59	10.62	14.19	—	14
	3	6.41	7.02	7.54	10.72	13.96	—	21
	4	6.32	6.84	7.63	10.97	13.86	—	28
FEB	5	6.22	6.75	7.76	10.93	13.86	—	4
	6	6.13	6.89	7.94	11.03	13.81	—	11
	7	6.17	6.93	8.17	11.23	13.66	—	18
	8	6.21	7.02	8.49	11.27	13.41	—	25
MAR	9	6.17	7.02	8.62	11.37	13.21	—	4
	10	6.12	6.93	8.89	11.29	13.44	—	11
	11	6.17	6.89	9.02	10.83	13.71	—	18
	12	6.21	6.85	9.16	11.10	13.76	—	26
APR	13	6.31	6.80	9.38	11.24	13.81	—	1
	14	6.36	6.76	9.38	11.46	13.66	—	8
	15	6.36	6.85	8.94	11.69	13.25	—	15
	16	6.45	6.80	8.28	11.82	13.03	—	22
	17	6.55	6.80	8.74	11.96	12.78	—	29
MAY	18	6.64	6.85	8.56	11.91	12.88	—	6
	19	6.64	6.89	7.88	11.82	12.73	—	13
	20	6.64	6.89	8.18	11.73	12.83	—	20
	21	6.83	6.80	8.32	11.63	12.88	—	27
JUN	22	6.83	6.76	8.45	11.54	13.01	—	3
	23	6.83	6.66	8.35	11.59	13.21	—	10
	24	6.83	6.71	8.17	11.69	13.46	—	17
	25	6.93	6.80	8.26	11.69	13.41	—	24
JUL	26	6.97	6.76	8.49	11.79	13.36	—	1
	27	6.97	6.76	8.66	11.92	13.21	—	8
	28	6.97	6.81	8.75	12.03	13.08	—	15
	29	6.96	6.86	8.84	12.25	12.76	—	22
	30	6.87	6.95	8.95	12.35	12.71	—	29
AUG	31	6.69	6.86	9.40	12.50	...	—	5
	32	6.69	6.86	9.44	12.80	...	—	12
	33	6.78	6.90	9.34	13.30	...	—	19
	34	6.69	6.99	9.52	13.79	...	—	26
SEP	35	6.73	7.13	9.70	13.97	...	—	2
	36	6.65	7.22	9.61	14.07	...	—	9
	37	6.51	7.27	9.71	13.66	...	—	16
	38	6.60	7.27	9.86	13.43	...	—	23
OCT	39	6.60	7.35	10.01	13.78	...	—	30
	40	6.60	7.40	10.01	13.54	...	—	7
	41	6.67	7.67	9.86	13.36	...	—	14
	42	6.77	7.76	9.75	13.81	...	—	21
	43	6.91	7.76	10.02	13.71	...	—	28
NOV	44	6.91	7.67	10.43	13.16	...	—	4
	45	6.87	7.67	10.65	12.21	...	—	11
	46	6.78	7.67	10.50	12.48	...	—	18
	47	6.82	7.76	10.50	12.78	...	—	25
DEC	48	6.90	7.63	10.60	12.96	...	—	2
	49	6.90	7.53	10.82	13.61	...	—	9
	50	7.04	7.62	11.42	13.71	...	—	16
	51	7.25	7.58	11.58	13.94	...	—	23
	52	7.25	7.58	11.03	14.09	...	—	30
	53			10.81	0	0	—	

"BOND BUYER'S" Index of 20 Municipal Bonds

	Week	1978	1979	1980	1981	1982	1983	Week Ending
JAN	1	5.64	6.58	7.32	9.49	13.38	9.49	7
	2	5.75	6.50	7.30	9.57	13.44	9.39	14
	3	5.74	6.48	7.28	9.68	13.16	9.46	21
	4	5.70	6.30	7.33	9.91	13.15	9.66	28
FEB	5	5.63	6.22	7.62	9.90	13.13	9.74	4 High
	6	5.59	6.31	7.71	9.99	13.09	9.72	11
	7	5.61	6.33	7.75	10.22	12.96	9.53	18
	8	5.65	6.38	8.46	10.27	12.70	9.34	25
MAR	9	5.63	6.42	8.72	10.40	12.53	9.04	4
	10	5.58	6.35	8.34	10.34	12.71	9.22	11
	11	5.56	6.30	9.08	9.81	12.99	9.19	18
	12	5.59	6.29	9.20	10.09	13.04	9.15	25
APR	13	5.69	6.28	9.44	10.21	13.13	9.37	1
	14	5.76	6.25	9.44	10.45	12.99	9.25	8
	15	5.74	6.33	9.07	10.70	12.54	9.04	15
	16	5.79	6.30	7.89	10.80	12.29	9.01	22
	17	5.89	6.26	8.11	10.94	11.97	8.92	29
MAY	18	5.98	6.27	7.96	10.90	12.04	8.78	6 Low
	19	5.99	6.30	7.11	10.83	11.82	8.86	13
	20	5.98	6.30	7.44	10.73	11.96	9.29	20
	21	6.16	6.21	7.72	10.84	11.99	9.51	27
JUN	22	6.19	6.18	7.73	10.59	12.13	9.79	3 High
	23	6.18	6.09	7.67	10.63	12.40	9.69	10
	24	6.16	6.11	7.53	10.73	12.63	—	17
	25	6.26	6.18	7.55	10.74	12.62	—	24
JUL	26	6.29	6.12	7.76	10.85	12.58	—	1
	27	6.31	6.08	7.88	10.97	12.47	—	8
	28	6.32	6.11	7.95	11.09	12.36	—	15
	29	6.26	6.15	8.03	11.34	12.01	—	22
	30	6.24	6.19	8.19	11.44	11.97	—	29
AUG	31	6.12	6.14	8.59	11.63	11.87	—	5
	32	6.03	6.13	8.61	11.94	11.86	—	12
	33	6.19	6.18	8.53	12.49	10.82	—	19
	34	6.11	6.23	8.68	12.97	10.38	—	26
SEP	35	6.16	6.36	8.85	13.10	10.74	—	2
	36	6.13	6.47	8.78	13.21	10.75	—	9
	37	6.02	6.49	8.82	12.79	10.74	—	16
	38	6.12	6.57	8.98	12.57	10.58	—	23
OCT	39	6.09	6.56	9.18	12.93	10.48	—	30
	40	6.07	6.64	9.22	12.71	9.75	—	7
	41	6.10	7.12	9.01	12.53	9.25	—	14
	42	6.14	7.18	8.81	12.99	9.69	—	21
	43	6.21	7.38	9.06	12.99	10.05	—	28
NOV	44	6.22	7.26	9.45	12.44	9.96	—	4
	45	6.17	7.27	9.64	11.43	9.92	—	11
	46	6.11	7.31	9.50	11.71	10.20	—	18
	47	6.16	7.38	9.50	11.98	10.16	—	25
DEC	48	6.29	7.26	9.61	12.18	10.23	—	2
	49	6.29	7.17	9.84	12.89	10.13	—	9
	50	6.45	7.26	10.42	13.00	10.05	—	16
	51	6.67	7.22	10.56	13.17	9.84	—	23
	52	6.61	7.23	9.99	13.30	...	—	30
	53			9.76		9.58		31

"BOND BUYER'S" Index of 25 Revenue Bonds

	Week	1979	1980	1981	1982	1983	Week Ending
JAN	1	—	8.18	10.41	14.29	10.37	7 High
	2	—	8.21	10.34	14.32	10.10	14
	3	—	8.15	10.72	14.12	10.15	21
	4	—	8.20	11.07	14.09	10.31	28
FEB	5	—	8.30	10.84	14.03	10.30	4
	6	—	8.47	11.06	13.89	10.23	11
	7	—	8.53	11.06	13.75	10.08	18
	8	—	9.14	11.07	13.52	9.91	25
MAR	9	—	9.49	11.10	13.35	9.62	4
	10	—	9.71	11.03	13.59	9.95	11
	11	—	9.91	10.67	13.73	9.85	18
	12	—	9.99	10.80	13.79	9.73	25
APR	13	—	10.19	10.92	13.70	9.80 75	1
	14	—	10.25	11.17	13.60	9.60	8
	15	—	9.90	11.30	13.22	9.37	15
	16	—	9.19	11.48	12.93	9.38	22
	17	—	9.29	11.71	12.84	9.26	29
MAY	18	—	9.03	11.68	12.82	9.21	6 Low
	19	—	8.15	11.65	12.69	9.28	13
	20	—	8.24	11.54	12.74	9.77	20
	21	—	8.51	11.45	12.78	9.96	27
JUN	22	—	8.58	11.48	12.94	10.25	3
	23	—	8.51	11.47	13.15	10.26	10
	24	—	8.44	11.48	13.51	—	17
	25	—	8.39	11.54	13.58	—	24
JUL	26	—	8.52	11.66	13.58	—	1
	27	—	8.66	11.73	13.36	—	8
	28	—	8.70	11.87	13.32	—	15
	29	—	8.77	12.01	13.12	—	22
	30	—	8.89	12.12	13.05	—	29
AUG	31	—	9.31	12.34	12.90	—	5
	32	—	9.47	12.55	12.84	—	12
	33	—	9.39	13.04	12.28	—	19
	34	—	9.62	13.89	11.85	—	26
SEP	35	—	9.78	14.10	11.97	—	2
	36	—	9.68	14.24	11.64	—	9
	37	—	9.73	13.78	11.47	—	16
	38	7.23	9.92	13.62	11.10	—	23
OCT	39	7.25	10.02	13.98	10.98	—	30
	40	7.35	10.07	13.83	10.31	—	7
	41	7.75	9.94	13.57	9.78	—	14
	42	7.94	9.66	13.94	10.47	—	21
	43	8.15	9.93	13.97	10.82	—	28
NOV	44	8.05	10.27	13.54	10.66	—	4
	45	8.16	10.43	12.66	10.67	—	11
	46	8.05	10.39	13.06	10.79	—	18
	47	8.24	10.38	13.26	10.85	—	25
DEC	48	8.07	10.51	13.49	10.92	—	2
	49	7.97	10.94	13.89	10.79	—	9
	50	8.14	11.30	13.95	10.81	—	16
	51	8.10	11.41	14.12	10.66	—	23
	52	8.11	10.96	14.23	...	—	30
	53		10.81		10.34		31

Table 9
Tax Exempt/Taxable Yield Ratio

	Short Term	Long				Bond Buyer Index
		Aaa	Aa	A	Baa	
1981 January	40.2	70.1	68.0	68.7	65.9	9.90%
February	38.9	70.9	70.1	69.2	66.0	
March	43.4	71.3	70.5	69.7	67.8	
April	44.3	70.5	70.8	71.1	69.7	
May	40.0	69.0	69.5	70.2	70.5	
June	43.0	71.7	71.5	71.4	70.9	10.85%
July	44.9	71.0	71.9	71.9	71.4	
August	46.2	74.5	77.7	78.6	78.2	
September	59.4	74.6	79.0	81.0	80.4	
October	59.9	78.2	79.0	78.0	78.0	
November	53.7	77.2	74.9	76.2	77.4	
December	54.9	82.2	74.4	80.0	80.4	13.30%
1981 Annual Average	47.4	73.4	73.1	73.8	73.1	
1982 January	52.6	81.0	81.5	83.3	81.6	13.11%
February	49.9	79.9	80.7	80.7	80.5	
March	54.3	81.9	80.3	83.1	81.5	
April	53.7	80.6	81.1	79.9	79.2	
May	54.6	77.5	77.2	76.6	75.4	
June	55.0	78.0	78.3	77.0	75.3	12.58
July	56.2	78.5	79.9	78.0	78.4	
August	55.7	77.9	75.3	72.4	75.7	
September	46.8	74.9	75.4	70.5	76.0	
October	48.1	75.5	73.3	68.9	72.4	
November	48.8	80.9	77.8	73.5	75.5	
December	56.2	78.9	79.2	74.9	76.4	9.56%
1982 Annual Average	52.7	78.8	78.3	76.6	77.3	
1983 January	53.2	76.3	77.2	73.0	78.8	
February	46.1	73.3	72.4	70.9	75.9	
March	51.7	71.8	71.6	70.2	73.8	9.38%

SOURCES: Short Term: Federal Reserve Bulletin, Bank of America Quote Sheet, Weekly Money Market Summary of Continental Illinois National Bank and Trust Company

Long Term: Moody's Bond Survey

TABLE 4 - MUNICIPAL BOND SALES SUMMARY BY USE OF PROCEEDS
(AMOUNTS IN THOUSANDS)

USE OF PROCEEDS	TOTAL MAR. 1986 AMOUNT	NUMBER	TOTAL (3 mo) 1986 YTD AMOUNT	NUMBER	TOTAL (3 mo) 1985 YTD AMOUNT	NUMBER	CHANGE 1985 TO 1986 AMOUNT	PCNT
Elementary & Second	$ 347,108	75	$ 833,651	166	$ 481,373	146	$ 352,278	[illegible]
Colleges & University	391,760	24	711,240	51	417,919	38	293,321	70.1
Others	61,850	06	687,209	17	8,410	03	678,799	***
EDUCATION : TOTAL	800,718	105	2,232,086	233	907,702	187	1,324,384	145.9
Roads, Bridges	146,319	30	333,509	54	215,542	48	117,966	54.7
Ports, Airports	378,150	10	504,319	17	217,648	18	286,670	131.7
Other	290,250	06	585,500	18	283,100	32	302,400	106.7
TRANSPORTATION: TOTAL	814,719	46	1,423,343	89	716,287	93	707,056	98.8
Poll'n Control	51,350	02	79,860	08	74,325	06	5,535	7.4
Water & Sewer	464,353	101	1,226,600	203	888,266	214	338,334	38.0
Electric & Gas	1,122,000	19	11.3% 1,890,913 ✓	41	15%· 2,000,350 ✓	30	-21,837	-1.0
Other	73,335	11	435,940	20	229,836	24	196,007	86.0
UTILITIES & CONSERV	1,711,438	129	3,706,341	272	3,230,062	273	476,279	14.7
Public Housing	1,426,471	112	14.6 2,568,615 ✓	108	9.9 1,326,434 ✓	113 ✓	1,242,181	93.6
Hospitals	677,808	47	1,562,525	152	1,848,350	187	-285,825	-14.3
Others	69,500	03	112,620	08	132,606	20	-19,986	-15.0
SOCIAL WELFARE: TOTAL	2,173,779	162	4,263,760	268	3,307,389	320	956,371	28.9
INDUSTRIAL AID, OTHER	168,684	40	1.8% 329,888 ✓	65	6% 687,[illegible] ✓	301	-357,594	-52.5
INDUS AID-POLLU CNTRL	103,465	04	449,326	16	962,105	44	-512,839	-53.3
PUBLIC SERVICES	56,350	16	208,210	29	129,875	39	78,335	60.3
RECREATION	23,770	12	151,388	19	243,395	22	-92,007	-37.8
CLASSIFIED MISC	47,769	06	106,990	10	5,675	04	101,315	1785.3
VARIOUS PURP, UNKNOWN	748,080	101	1,913,779	179	2,111,194	213	-197,415	-9.3
TOTAL NEW CAPITAL	$ 6,709,213	601	$14,745,102	1,285	$12,272,318	1,395	$ 2,472,784	20.1
Refunding	$ 1,178,560	103	$ 2,795,117	159	$ 1,087,634	41	$ 1,707,483	157.0
Advanced Refunding	00	00	00	00	3,050	01	-3,050	-100.0
TOTAL REFUNDING	$ 1,178,560	103	$ 2,795,117	159	$ 1,090,684	42	$ 1,704,433	156.3
GRAND TOTAL YTD	$ 7,887,773	704	$17,540,219	1,444	$13,363,002	1,436	$ 4,177,217	31.3

Mr. PICKLE. Well, I thank all of you gentlemen. You are very cooperative. You have open minds on this subject. Obviously you want us to do what you think is right, but you all do not want any changes made in the IDB program.

Do you disagree that the use of the IDB bonds has not grown so much today that they now constitute over half the tax-exempt program? Do you dispute that?

Mr. PREESHL. Mr. Chairman, the problem is confusing, I think, IDB bonds with private purpose bonds. If private purpose bonds, as I understand them, include housing, pollution control, electric and gas, student loans and IDB's, they have grown.

Mr. PICKLE. We have to use broad terminology, Mr. Preeshl, of private purpose use as the law is constituted now. As it is constituted now, this allows your air pollution control and your sewage and the other projects. So it has to be the broad picture of it.

And I am saying that by virtue of the fact that those are available now, that the tax-exempt program, even with the changes we made last year, they now outweigh the normal tax-exempt program. And if it continues to grow, it is estimated that in another 1 to 5 to 10 years they will completely dwarf the revenue tax-exempt program.

Now then, where are the various cities going to get funds to finance their programs? Do they all switch to industrial development bonds and the Federal Government then loses that revenue? It seems to me like inevitably that is where we are headed for if we do not try to control it.

Now, you are saying it is too soon, Mr. Preeshl, and one of the others said, because of the change that we made last year; that you worked with one of our colleagues to help limit it. I say, mighty little limitation you made last year. We started out limiting it, but when you and others got to working on that bill we lost most of the things we were trying to advance. That is my view of it.

Now, we are coming back again to say we have to make some additional changes, and all we are recommending in the bill that is before us is about a 10-percent reduction. It does not kill it; it just extends the life. And yet you come back and you do not want to take that.

Now, how do we control the growth of these bonds unless we make some alteration? Yes, sir?

Mr. HELTZER. Mr. Pickle, I think it is important to emphasize that there is a distinction here with a number of the panelists.

Mr. PICKLE. Who are you, sir?

Mr. HELTZER. I am Harold Heltzer. I am outside tax counsel for Brooklyn Union Gas.

Mr. PICKLE. I had not recognized you, but I will recognize you now since you asserted yourself. Go right ahead.

Mr. HELTZER. There is a distinction between regulated public utilities and those which are not regulated public utilities, a widget company, for example. There are currently provisions in the Internal Revenue Code which require normalization for public utilities, and that means, to use Mr. Conable's phrase just before, that there is no pyramiding of the benefits of the ACRS and IDB's in connection with public utilities.

These public utilities have to pass through those benefits to the customers, to the consumers. Whereas if we are talking about other nonregulated public utilities, those benefits can be—there can be a double dip there. So there is a major distinction between public utilities on the one hand——

Mr. **Pickle**. You are saying that the gentleman on the panel who just preceded you, who represented a department store and they were building all of their plants, or a good many of them, by IDB's, that you would cut that out or limit that or control that, but not the public purpose ones? That is, strictly utilities?

Mr. **Heltzer**. I was not referring to that at all. All I was doing was making a distinction, that there is no revenue loss with regard to the public utilities, regulated public utilities, to the same extent that there is with regard to a widget company.

And, second, there is no double dip or pyramiding effect in connection with regulated public utilities, as there may be in connection with nonregulated——

Mr. **Pickle**. I will concede there is a difference between the public utilities, electric utilities, and a private business like Du Pont or a department store. I recognize there is a difference. But under the law they both get it.

I am not going to take the committee's time. We have gone a long time. But I am just going to make reference here to testimony of Mr. Waters. Here is a statement, and I will repeat it for the committee again, on page 3:

> We feel that this important form of financing represents a unique partnership between the Federal Government and the electric utilities which was designed to meet the very expensive requirements of an equally important public policy. Now, at the same time we recognize that Congress must raise additional revenues and cut spending to reduce the federal budget deficits.

You pointed that out to us. You and a lot of other business people, particularly the utility people, are telling us always, cut spending and reduce the deficit. "However, we urge you not to make changes in the tax law that will further weaken the financial condition of our company, and place additional burdens on our ratepayers."

So that is the whole ballgame we are talking about here today.

Mr. **Waters**. I understand, sir, what you are talking about. And my feeling is that the pollution control financing which I am addressing is something in the matter of public policy. It is something that we are mandated to do, it is something that morally we should be doing. And in my own mind—and this is only me talking—if I were trying to establish a legislative guideline, I think I would look at whether it serves an overall public purpose or whether it serves a purpose directed toward an individual group or grouping?

I feel that pollution control abatement is one of those things that falls into that particular category, that it is good for the entire populace, not just good for a particular group.

Mr. **Pickle**. Well, I do not want to be regional or provincial about this, but I remember one of our Senators from Louisiana made the statement: "Don't tax me, don't tax thee, tax that fellow behind the tree."

Mr. **Conable**. You have to admit that we put these folks in the same boat. We make them put a quarter of their capital investment into something that has nothing to do with their business. I mean, it has nothing to do with the productivity that they achieve. That is the problem.

Let me tell you, if I may interrupt, from the point of view of a fellow who has been on this committee a while, we have a lot of problems in this area and they are virtually insoluble. One of them is, you folks are mostly from utilities and it is not your fault that you are not permitted to accumulate enough capital to meet the future needs of your consumers. Particularly you, Mr. Fuller. You come from California, which is one of the greatest little old places, to require the flowthrough of all tax benefits to the consumers.

And then, of course, you have got to come back to us and get additional tax preferences so that you can accumulate the capital needed to meet the needs of the consumers. And, of course, then the minute we give you the additional tax preference, if we are going to be fair, we have to give it to the widget manufacturers, too. At least that is the way it seems to the widget manufacturers.

So we are constantly in a pull back and forth here. One of the problems of regulated industries is that you do not really care. One way or another, you have to meet the mandate of your charter, which is to provide utility services to people. So one way or another you have to get that capital.

Well, of course, if your rate agencies do not let you accumulate it in some way by giving you an adequate rating, then you come to us and want to be bailed out. And we complicate the tax law to try to accommodate you.

Over the years, we have loaded more stuff on the taxpayers because of your California rate agency than almost anything else you can think of around here, because we had to find some new ingenious way to get some capital to you so that you can meet the needs of a growing population. And I know you are growing because I come from New York, like Mr. Waters. And you know, you are growing at our expense. Our taxpayers are paying for consumer protection in California as a result of your rate agencies insisting on flowthrough.

This is the kind of dilemma we get into all the time here. Now, Jake, are we going to have pollution control or are we not? And the question is, is that a public purpose? If it is a public purpose, then why in the world not let IDB's be used for it?

As you know, you can always do wonderful things for people if you just take them outside the tax system. And that is what we are gradually doing. We are narrowing our tax base to the point where we are going to have a consumer tax. In effect, we are going the same route in your case now. By putting taxes on in order to protect your consumers, we are going to wind up taxing your consumers because we put in so many tax preferences to benefit your consumers. One of these days we are going to wind up without enough to run the Federal Government.

So it is this kind of a circular thing. We go around in circles in an effort to keep everybody happy, and in the process we just make a mess of everything. And I know you are in here to tell us we have to continue to do that.

Mr. **Fuller**. Mr. Conable, perhaps you would join me in asking our Chairman to please strike from the record any head motions I may have made in connection with your comments about California.

Mr. **Conable**. He agreed with me about the California rate agency—no, I did not say that.

Mr. **Pickle**. Well, we have that record straight.

I am not going to prolong this. Part of the testimony made just preceding you, Mr. Bean, he has already been here, he said that Congress should provide for the financing of abatement and process-oriented technologies to provide for the use of cost-efficient pollution control technologies that are available.

Currently the Tax Code provides an incentive to create pollution rather than to prevent pollution, creation, abatement, and process technology, because only control technologies are eligible for PCIDB financing. He concludes by saying, by providing for PCIDB financing of abatement process-oriented technologies as mandated, nonproductive cost controls can be lessened.

Well, we are just increasing credits. It is the same approach we use now for technologies that are outdated, and we give you a tax credit for it. I do not know where we are going on these things.

I know you can argue that your rates will be less because you are protecting the public, and we all recognize that there is validity to that argument. Yet we sit up here on the committee trying to see where is the Federal Government going.

And I go back again, Mr. Waters, to your point. You want us to stop spending. You want us to cut down the deficit, but do not stop the tax credit that we are enjoying because it is good for our business.

Mr. **Waters**. I understand what you are saying.

Mr. **Pickle**. And we are all in pretty much the same boat.

Mr. **Waters**. I understand what you are saying. I am just looking at pollution control abatement as being something in the public interest. And the one thing I am concerned about is that the H.R. 1635 as it is written retroactively removes the exemption, I think just by silence, for all facilities that were under construction prior to July 1, 1982, which provision was enacted as part of TEFRA.

This is a major concern to us in that, frankly, it covers a major portion of facilities that we have already got committed.

Mr. **Pickle**. Well, all the bill does, Mr. Waters, with respect to this ACRS is we do give full ACRS deduction for low-cost housing, housing rentals. We give an extended life to other areas such as sewage, and solid waste, and air pollution. You want them to have the same ACRS credit that they are getting now.

Mr. **Waters**. I am interested in the grandfather clause, sir, that is in the original TEFRA bill.

Mr. **Pickle**. Generally, all these other classifications, they want the ACRS or a transition rule. All I am doing is saying to limit it to say, we will give you more rapid depreciation, but it will not be the same as under the ACRS in some respects. And you would think I had fired a gun to kill the whole IDB program, and all I am doing is trying to make about a 10-percent correction. And you come here testifying, but do not do it.

And that is something the committee has to figure out, what do we do? We have to make some changes, and if we do we have to find out what is in the public interest. But I know you share the same concern we do, and we in turn are trying to represent the public interest as we see it. So maybe together we can find some way to control these facilities.

Well, I thank you all very much. I appreciate your testimony. I am glad you have come, and thank you for waiting so patiently so long today. Thank you.

The committee is adjourned until 9:30 in the morning.

[Whereupon, at 4:25 p.m., the hearing was adjourned, to reconvene at 9:30 a.m., Thursday, June 16, 1983.]

TRENDS IN MUNICIPAL FINANCING AND THE USE OF TAX-EXEMPT BONDS TO FINANCE PRIVATE ACTIVITIES

THURSDAY, JUNE 16, 1983

House of Representatives,
Committee on Ways and Means,
Washington, D.C.

The committee met at 9:30 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

Chairman Rostenkowski. The committee will come to order. The Chair calls Representative AuCoin.

Mr. AuCoin. Thank you, Mr. Chairman.

Chairman Rostenkowski. Welcome to the committee, Les. We always enjoy listening to your testimony. If you are ready to proceed, the committee is ready to receive your statement.

STATEMENT OF HON. LES AuCOIN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OREGON

Mr. AuCoin. Mr. Chairman, I want to thank you very much for your hospitality this morning and thank you for your leadership in scheduling today's hearings on the issue of mortgage revenue bonds.

I appreciate the opportunity to appear before your committee and I am grateful for the efforts of my colleagues who are on your committee, Mr. Downey and Mr. Frenzel, who sponsored H.R. 1176 to repeal the sunset date on single-family mortgage revenue bonds.

Mr. Chairman, I come to you as a member who served for 6 years on the Housing Subcommittee of the House Banking Committee and I care very much for the direction this country is going on housing policy. It is clear to me that we have reached a critical juncture in terms of the mortgage revenue bond program. We can choose to continue a very valuable program that provides a host of social and economic benefits or we can let it die.

As a cosponsor of this legislation and as a member from the Pacific Northwest with a longstanding commitment to housing, I strongly support the first option. I hope your committee, after hearing the witnesses that will follow, will agree with that position. The mortgage revenue program is important not only to States with a timber-based economy such as mine, but also to State and local governments and to homebuilders and to home buyers across the Nation.

It means actualizing the dream of homeownership for thousands of people and that is not hyperbole in saying so. It means social and economic development and it means jobs.

Mr. Chairman, I think we need to keep in mind that it is housing and homeownership that has enabled middle-income families to create some measure of personal wealth and to be able to leverage that wealth. For that very reason, it is my contention that homeownership has helped make capitalists out of the lower and lower middle-income class in this country. We can ill afford to lose that. If we do lose that, I think we change the character of our society and our economy.

I can point with great satisfaction to Oregon's experience with the mortgage revenue bond program. Since the Oregon Housing Division issued its first bonds in 1977, the program has financed the shelter needs of over 8,500 Oregonians who are first-time home buyers with median incomes of between $14,000 and $18,000 a year. In contrast, the U.S. League of Savings Associations report that the median income of home buyers receiving conventional financing in 1981 was over $39,000.

With the use of this bonding authority, Oregon has been able to design several innovative mortgage financing programs. For example, Oregon has used uncommitted funds from prior bond sales to finance homes rehabilitated through the city of Portland's recycled housing program. The recycled housing program has enabled Portland to acquire 21 vacant deteriorating or abandoned properties, fully rehabilitate them and sell them to families with average incomes of little more than $15,000—the majority of which have been minorities and female head of households.

Vital as the mortgage revenue bond program is, Mr. Chairman, to low- and moderate-income families, it is just as important to the housing industry and economic development. So far, the 1980's have been dismal years, to say the least, for housing. Yet, this is the decade that will see the Nation's greatest need for housing as the crest of the baby boom—42 million strong—enters the home buying years.

Although the housing industry is just beginning to emerge from its trenches, it is not at all clear that it will make it across the battlefield without being shot down. The industry is teetering on the fence between nirvana on the one side and never-never land on the other. Signs of a faltering recovery are already evident. Some of the Nation's top market analysts are now predicting that interest rates on conventional loans have hit bottom and will rise to 14 percent by this fall.

I find it ironic that just 1 year ago, the President was embracing the mortgage revenue bond program as a life preserver for the floundering housing industry when some of us were spearheading a fight for an emergency direct housing stimulus program. At that time, the administration was saying they favored mortgage revenue bonds in lieu of supporting an emergency stimulus program. Then, saying housing was one of his top social priorities and declaring that the American dream of homeownership had turned into a nightmare, the President told realtors at a Washington conference last March that he supported changes in the mortgage revenue bond program to aid the depressed housing industry.

In April of 1982, a HUD factsheet further stated that the administration supported changes in the program as a way to assist the housing sector that was consistent with the President's economic recovery program. Mr. Chairman, that element of the program cannot continue if this program is allowed to lapse.

This year, I challenge the administration to live up to its words about housing as a top priority by keeping mortgage revenue bonds on the books to help stabilize housing production during a very shaky period of recovery. I hope the committee will agree with me on that matter.

To those who criticize the mortgage revenue bond program as a drain on the Treasury, I would remind them that the flow of funds is not one way. Housing, unlike any other industry, has the unique ability to spawn sales and jobs not only in the construction industry, but in numerous businesses directly and indirectly spurred by housing activity. It is job intensive and from the standpoint of economic development it is growth intensive.

In my own State of Oregon, the program has produced a conservative estimate of over 1,000 jobs, over $7 million in Federal and State employment tax revenues, and more than $123 million in economic activity. I cannot emphasize enough just how important this kind of stimulus is to a state like mine and to the people of this country.

Now, I understand there is a reluctance on the part of the administration to continue the mortgage revenue bond program. Mr. Chairman, I am just as concerned as the administration is about the massive prospective deficits looming over the financial markets. I want to say in many ways I am even more concerned than some in and outside the administration about one of the key large ticket items that is fueling that deficit. I would specifically call this committee's attention to the costs of an unrestrained military buildup that sacrifices productive jobs and economic investments such as housing, in the name of military superiority. To eliminate the mortgage revenue bond program while allowing runaway increases in defense spending is a serious mistake.

I must question anyone's commitment to housing and homeownership when anyone asks for $94 billion worth of new weapons while telling the American people that capital must be funneled out of housing into so-called more productive uses in the economy.

Mr. Chairman, I want to say for the record and for your committee that I cannot think of anything more productive as an expenditure or as an investment than housing for the American people and the American economy. For the average American worker, it is one of the few ways to increase personal economic assets and leverage those assets so they have a piece of the rock. For the national economy, it is a job-intensive tonic second to none.

Treasury Secretary John Chapoton has suggested that a more cost-effective direct subsidy program could provide the same benefits as mortgage revenue bonds. I must say in response after watching the President kill my emergency housing stimulus bill last year during one of the most severe housing crisis this Nation has witnessed, I am convinced that such an alternative would never see the light of day in this Congress.

But more than that, Mr. Chairman, a direct subsidy program is no substitute for the mortgage revenue bond program. This program makes possible a local housing delivery system that is responsive to individual community needs. The case I have cited in Oregon and in my district in Portland in particular, is one of the cases in point. I believe it is the President's concept of new federalism in action.

For all these reasons, Mr. Chairman, I believe that continuation of the mortgage revenue bond program is in the best interest of the country's economy. The interests of the Nation's communities is best served and the Nation's home buyers are best served. I thank you for the opportunity to share these views with you today.

[The prepared statement follows:]

STATEMENT OF HON. LES AUCOIN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OREGON

Mr. Chairman, I would like to commend your leadership in moving diligently on the issue of mortgage revenue bonds. I appreciate this opportunity to appear before your Committee today and am grateful for the efforts of my colleagues, Mr. Downey and Mr. Frenzel, who have sponsored H.R. 1176, to repeal the sunset date on single-family mortgage revenue bonds.

Mr. Chairman, we have reached a critical juncture in terms of housing and the mortgage revenue bond program. We can choose to continue a very valuable program that provides a host of social and economic benefits, or we can let it die. As a cosponsor of this legislation and a member from the Northwest with a long-standing commitment to housing, I strongly support the first option.

The mortgage revenue bond program is important not only to the timber-based economy in my own state, but to state and local governments and home builders and home buyers across the nation. It means the American dream of homeownership. It means social and economic development. It means jobs.

I can point with pride to Oregon's own experience with mortgage revenue bonds. Since the Oregon Housing Division issued its first bonds in 1977, the program has financed the shelter needs of over 8,500 Oregonians who are first-time homebuyers with median incomes of between $14,000 and $18,000. In contrast, the U.S. League of Savings Associations reports that the median income of homebuyers receiving conventional financing in 1981 was over $39,000.

With the use of this bonding authority, Oregon has also been able to design several innovative mortgage financing programs. For example, Oregon has used uncommitted funds from prior bond sales to finance homes rehabilitated through the City of Portland's Recycled Housing Program. The Recycled Housing Program has enabled Portland to acquire 21 vacant or abandoned properties, fully rehabilitate them and sell them to families with average incomes of little more than $15,000—the majority of which have been minorities and female head of households.

Vital as the mortgage revenue bond program is to low and moderate income families, it is just as important to the housing industry and economic development. So far, the 1980's have been dismal years for housing. Yet, this is the decade that will see the nation's greatest need for housing as the crest of the baby boom—42 million strong—enters the homebuying years.

Although the housing industry it just beginning to emerge from its trenches, it is not at all clear that it will make it across the battle field without being shot down. The industry is teetering on the fence between nirvana and never never land. Signs of a faltering recovery are already evident. Some of the nation's top market analysts are now predicting that interest rates on conventional loans have hit bottom and will rise to 14 percent by this fall.

I find it ironic that just one year ago the President was embracing the mortgage revenue bond program as a life preserver for the floundering housing industry when some of us were spearheading a fight for a direct housing stimulus program. In fact, he favored mortgages revenue bonds in lieu of supporting an emergency stimulus program. Then, saying housing was one of his top social priorities and declaring that the American dream of home ownership had turned into a nightmare, the President told realtors at a Washington conference last March that he supported changes in the mortgage revenue bond program to aid the depressed housing industry.

In April of 1982, a HUD fact sheet further stated that the Administration supported changes in the program as a way to assist the housing sector that was consistent with the president's economic recovery program.

This year, I challenge the administration to live up to its words about housing as a top priority by keeping mortgage revenue bonds on the books to help stabilize housing production during a very shaky period of recovery. And, I hope the Committee will do the same.

To those who criticize the mortgage revenue bond program as a drain on the Treasury, I would remind them that the flow of funds is not one way. Housing, unlike any other industry, has the unique ability to spawn sales and jobs not only in the construction industry, but in numerous businesses directly and indirectly spurred by housing activity.

In my own state, the program has produced a conservative estimate of over 1,000 jobs, over $7 million in federal and state employment tax revenues, and more than $123 million in economic activity. I cannot emphasize enough just how important this kind of stimulus is to the Northwest which is recession weary and in the words of George H. Weyerhaeuser, (president of Weyerhaeuser Co.,) "still economically terribly depressed."

I understand there is reluctance on the part of the Administration to continue the mortgage revenue bond program. Mr. Chairman, I am just as concerned as the Administration is about the massive prospective deficits looming over the financial markets. In fact, I am extremely concerned about the costs of an unrestrained military build-up that sacrifices productive jobs and economic investments, such as housing, in the name of military superiority.

However, I seriously question the Administration's commitment to housing and homeownership when it is asking for $94 billion worth of new weapons while telling the American people that capital must be funneled out of housing into so-called more productive uses. Mr. Chairman, I cannot think of anything more productive than housing.

For the average American worker, it is one of the few ways to increase personal assets and get ahead. For the national economy, it is a tonic second to none.

Treasury Secretary John Chapoton has suggested that a more cost-effective direct subsidy program could provide the same benefits as mortgage revenue bonds. Last year, after watching the President kill my emergency housing stimulus bill during one of the most severe housing crisis this nation has witnessed, I am convinced that such an alternative would never see the light of day.

But more than that, a direct subsidy program is no substitute for the mortgage revenue program. The latter makes possible a local housing delivery system that is responsive to individual community needs. It is the President's "New Federalism" in action.

For all these reasons, I firmly believe that continuation of the mortgage revenue bond program is in the best interest of the nation's economy, the nation's communities and the nation's homebuyers.

Chairman ROSTENKOWSKI. Thank you, Les.

If mortgage subsidy bonds are to be continued, do you see any reason not to include veterans' housing bonds in the volume cap?

Mr. AUCOIN. That is an issue I would like to give some thought to. In Oregon, we have a unique situation because we have a very aggressive State veterans home loan program. I think it would work to the disadvantage of this mortgage revenue bond program that I have seen.

Chairman ROSTENKOWSKI. The problem that we recognize here is that these bonds may become contagious—first Oregon, then Pennsylvania. At the same time, we are still concerned with deficits, and the loss of revenue to the Treasury. It is like everything else—a well-intended program. But any program can turn into a run on the Treasury, and that is a concern of ours here. I wish that we had more cooperation from the Administration.

Mr. AUCOIN. I can understand the problems this committee faces because the loss of the revenue base that this country has gone through in the last few years is certainly substantial and I don't envy the headaches of the members of the committee in addressing this real problem. I would like to defer a definitive answer because it is such a sensitive issue in Oregon, and I would like to give it a great deal of thought before responding and extend my remarks for the record.

[The information follows:]

Mr. Chairman, I understand the Committee's concern about the expansion of these programs and the attendant loss of revenue to the Treasury.

However, in the case of Oregon's very vigorous program, I believe those concerns have been addressed by the State to a large extent.

Although Oregon has one of the largest veterans' programs in the country, it is not without limits. I think it would be a mistake to overstate the impact of these bonds on the Treasury and understate the benefits they provide.

The veterans' program in Oregon is already restricted. In 1981, the State Legislature placed a cap on the dollar volume of bonds that could be issued each year. It requires that a bonding limit be set in the biannual budget. Oregon has recognized that these limits are necessary to ensure that State's long-term credit rating.

In addition, Oregon has limited the scope of its program. It not only serves a narrow targeted clientele, but provides only one original loan per veteran, with few exceptions.

As for the problem of veterans' bonds and programs becoming contagious, there appears to be little evidence to warrant that fear. Few states have veterans' programs and despite the exemption placed in the 1980 Mortgage Subsidy Bond Act, they have not spread like wildfire.

In Oregon, veterans' mortgage loans make up a small percentage of total mortgages. Last year, only 8.8 percent of Oregon's mortgages were veterans' mortgages. This amounted to less than 3 percent of the State's total mortgage dollars. For the first 5 months of 1983, only 8.5 percent of Oregon's mortgages were made through the veterans' program—again, representing less than 3 percent of the total dollar amount of loans.

Certainly, cost is an issue. And it should be. At the same time, I would point out to the Committee that even though the veterans' program constitutes a small percentage of the State's total mortgage activity. It makes an important contribution to homeownership and the economy.

It is extremely important to veterans who would otherwise be unable to afford a home. Oregon's program was authorized by an amendment to the Oregon Constitution in 1945. It utilizes general obligation bonds and serves a significant public purpose. The use of these bonds for veterans' housing is based upon a long history that preceded the popularization and explosion in tax-exempt bonds issued by State and local government for housing.

It is extremely important to my State's timber-based economy. In tough years, when high interest rates dry up traditional sources of mortgage finance, the veterans' program is the only game in town. It helps keep many homebuilders and mills in business until the market recovers.

When we discuss the continuation of this type of financing and the mortgage revenue bond program, for that matter, I think we need to keep in mind the larger housing picture. The Administration has led efforts to retreat from our long-standing national commitment to housing and homeownership by drastically cutting federal housing programs and proposing to phase out government-sponsored credit agencies which are crucial to the lower-income and middle class home-buyer. The changing roles of our financial institutions are also making it more difficult to count on a steady supply of affordable mortgage money. If we shackle veterans' bonds, which are already capped in Oregon, we threaten to make the housing situation worse.

Given the fact that Oregon, with one of the largest veterans' programs, has imposed limits locally, and given the significant role it plays in the housing economy, I do not believe that it is necessary for the federal government to regulate veterans' bonds at this time.

I also believe that the costs to the Federal Treasury associated with these bonds, provide far more benefits in terms of jobs and economic activity than their tax loss to the Treasury. From the standpoint of homeownership and the economic boost veterans' bonds provide, I would hope that the Committee would accept an extension of the mortgage revenue bond program without further encumbrances.

Chairman **ROSTENKOWSKI**. Mr. Pickle will inquire.

Mr. PICKLE. Thank you, Mr. Chairman. I welcome my colleague to the hearings. You made a very important contribution to the hearings. We all want to continue the program to help the first-time home buyers so we are all in sympathy with the approach.

Our question is, is this the best way to help first-time home buyers? While it is one way, we have to ask ourselves what is the cost efficiency of this kind of thing? While I have not been directly involved in the analysis of the program, during the testimony yesterday, we asked the General Accounting Office their evaluation of the cost efficiency of the MRB program and the GAO said that in 1982—assuming we appropriated $100 of Federal money—in 1982, 28 percent of that would go to the home buyer and 74 percent would go to others, third-party people, intermediaries, bonding, lawyers, et cetera.

If those figures are correct from GAO, we have to ask ourselves—those figures were less than that in 1983 because the interest rates had gone down some.

But if the 1982 figure is correct, we have to ask is this a cost-efficient way to help home buyers? It is a way to do it, whether we should continue it and how is the problem we have to decide. That is a factor we face because we have such a large Federal deficit we have to keep that in mind. I mention that to you so you understand the problem we have.

Mr. AUCOIN. I appreciate that, Mr. Pickle. I think I have an appreciation for that. You have rightly identified an issue that should be of concern to the committee and that the committee ought to examine. However, I would suggest that GAO has been critical of a number of provisions in the tax code that this committee has written into law over the years because of a misunderstanding in my judgment of what the full effects of those provisions achieve.

I would guess that many of the same criticisms could be brought against the tax treatment on municipal bonds, and yet, I don't believe there is a constituency for repealing the current tax treatment on municipal bonds in light of the significant role such tax treatment plays at the grassroots level and in the economy. I am just suggesting that although the mortgage revenue bond program may have room for improvement, and while the program's benefits may not fall singularly to the home buyer, it is important to consider the ultimate dividends. The ultimate dividend is gained by those who realize homeownership who otherwise would not. It is gained by those who are constructing housing who otherwise would not be building virtually a thing. In effect, the total return in terms of revenue generated to the Treasury will offset the outlay.

Mr. PICKLE. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Are there further questions?

If not, thank you very much.

Mr. AUCOIN. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. The chair calls Representative Brown.

Mr. BROWN. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Welcome to the committee, Hank. We always look forward to your testifying before our committee. We appreciate the fact that you are joining us this morning to give us your observations on mortgage revenue bonds.

Mr. CONABLE. What does Colorado think?

STATEMENT OF HON. HANK BROWN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF COLORADO, ACCOMPANIED BY GEORGE OLSON, VICE PRESIDENT FOR RESEARCH, COLORADO STATE UNIVERSITY RESEARCH FOUNDATION, AND FRANK SILLER, ATTORNEY

Mr. Brown. Mr. Chairman, members of the committee, my focus is a rather narrow one this morning. I very much appreciate the opportunity to come before you. I have a bill that I think the committee will find to be particularly interesting. It does not grant tax-exempt status on borrowing instruments for institutions that don't already have it.

My focus is on H.R. 2118. I have prepared a statement, and I ask that it be submitted and inserted in the record.

Chairman Rostenkowski. Your entire statement will be included in the record. You may summarize.

Mr. Brown. I would just make a few remarks. I have with me Dr. George Olson, vice president for research with Colorado State Research Foundation, and also Frank Siller, an attorney here in town who helped us draft a bill that will help reduce attorneys' fees.

Very briefly, we are focusing on scientific research equipment used by colleges and universities. They are tax exempt under a variety of instruments that we have already provided.

All H.R. 2118 does is simplifies the procedures by which they issue the borrowing instruments. I think the committee will be interested in it because it does not involve extending tax-exempt status to private operations. All it does is simplify the process.

To make the point, I have asked them to indicate to me what is involved in placing one of these borrowing instruments now.

We are talking about a stack of papers this big. For a college or university to borrow money in these tax-exempt ways, you are talking about legal fees, accounting, fees, and administrative fees of approximately $50,000 on a $2 million loan. Obviously, costs can vary widely, but they tell me that is the average cost.

If we simplify the process, they believe you can do it for a stack of papers of this size, and for a cost somewhere in the neighborhood of $5,000. It is possible it could be a great deal less than that and obviously all these figures will vary. But what we are looking at is a potential of dramatically helping education and scientific research by eliminating or reducing the legal, accounting and administrative costs to borrow.

What we are asking for is not a raid on the Treasury. What we are asking for is a way to reduce legal and accounting fees in an area where the Congress has been comfortable in granting tax-exempt status.

My hope is it is an idea that intrigues the committee and I would be happy to answer questions or ask the experts we have with us to respond.

[The prepared statement follows:]

Statement of Hon. Hank Brown, a Representative in Congress From the State of Colorado

Mr. Chairman, I appreciate the opportunity to appear before the Committee to speak on behalf of my bill, H.R. 2118, the "Scientific Research Act of 1983."

We believe that in H.R. 2118 we have a way of significantly aiding education by eliminating some of the red tape, delays, and unnecessary legal expenses related to borrowing.

H.R. 2118 merely simplifies the use of tax-exempt financing now available to colleges and universities to acquire scientific research facilities and equipment. Such financing currently requires colleges and universities to use many different kinds of financial instruments, to find a cooperative investment banker who is willing to participate in these relatively small issues, and to obtain the expensive legal advice of tax counsel.

My bill would allow all financing of scientific facilities and equipment to be done at tax-exempt interest rates without regard to the nature of the financial instrument. The cost of the financing would be met by fees charged to those who actually use the equipment.

The revenue impact of H.R. 2118 would be negligible since the bill essentially streamlines financing mechanisms that already exist.

The passage of H.R. 2118 would encourage universities to solve their own problems of upgrading scientific equipment and not to rely on tentative government grants. It will also enable them to contribute to the resurgence of America's technological leadership around the world.

Tax-exempt financing is already available to universities through revenue bonds, industrial development bonds, municipal lease purchase agreements, and revolving lines of credit. The problem with these vehicles is that they are complicated and require a degree of legal and financial expertise not readily available at universities. Tax laws and IRS regulations so complicate these alternatives that university administrators are discouraged from going forward with an equipment financing program.

As the Committee knows, the quality of education has emerged as a key issue this year. It is widely recognized that today our ability to compete in international markets is tied closely to our ability to educate and train qualified people. Scientific research facilities and equipment now being used by American university laboratories are estimated to be at least ten years behind state-of-the-art facilities and equipment in use by their counterparts in industry and in Europe and Japan. Continued U.S. leadership in high technology requires a reversal of this situation.

Cost estimates of modernizing our universities' scientific facilities and equipment run as high as $4 billion. There are three principal options for meeting this cost: federal grants, gifts from industry, and tax-exempt, self-financing by universities.

Mounting U.S. deficits prevent federal grants from being an adequate solution, and industry gifts are not sufficient to make up the difference. Self-financing by universities must be a part of the solution. Tax-exempt bonds can become a major source of funding for acquiring and upgrading scientific facilities and equipment.

I know the Committee is concerned about using tax-exempt bonds for private purposes. H.R. 2118 is limited to the acquisition of scientific facilities and equipment by our colleges and universities. It meets the purposes I believe the Committee has in mind for tax-exempt instruments. It aids education in a material way by reducing red tape in this area. I hope the Committee will consider H.R. 2118 favorably.

Mr. **Pickle** [presiding]. Mr. Brown, we thank you for your testimony and I find your idea intriguing and we will look at your bill and give it consideration. Thank you.

Mr. **Brown**. Thank you, Mr. Chairman.

Mr. **Conable**. Mr. Chairman.

Mr. **Pickle**. Mr. Conable.

Mr. **Conable**. Could I ask, what is the basic thrust of your proposal? How do you do this without greatly reducing accountability and without eliminating the elements of targeting and other things which are considered desirable in any proposal of this sort?

Mr. **Brown**. If I may, I would like to call on Dr. Olson to respond to that, if it meets with the chairman's approval.

Mr. **Conable**. It is difficult to get more government without having more regulation, also.

Mr. **Brown**. Indeed.

Mr. **Conable**. So we could save administrative costs a lot if we just shoved the money on airplanes with shovels, but that is not necessarily desirable in terms of accountability. So how do you sacrifice the regulations, the complexity of the regulations without also sacrificing accountability to some extent?

Mr. OLSON. The primary——

Mr. PICKLE. Would you identify yourself.

Mr. BROWN. This is Dr. George Olson, vice president for research for Colorado State University. He has been very active in this field. A number of universities around the country have been working with him to put together borrowing packages for scientific and educational equipment.

Mr. PICKLE. Would you like to make a statement, Doctor?

Mr. OLSON. Yes. The primary accountability in any borrowing undertaken by a university is to the investor that buys the piece of paper, the bond, the lease participation certificate or what have you. The accountability to the investor does not diminish at all. What we are doing is taking a variety of borrowing instruments that we now must use and to satisfy the requirements of a host of sections of the tax code and IRS regulations and State and local laws, simplifying them by stating that if the debt instrument is for scientific equipment for a college or university, the interest on that instrument will be tax-exempt.

We do not change the accountability for the repayment of the principle or for the use of the funds.

Mr. CONABLE. I see. It is interesting.

Mr. BROWN. Perhaps we could walk through just a quick sample of an industrial revenue bond.

Mr. OLSON. It is a matter of several months' procedure in getting the inducement resolution from the county or municipality, working with legal counsel who is comfortable on opining on the type of financing you are doing. We are talking about financing small issues items that cost up to a few million dollars. We are buying scientific equipment that is not understood by the buying public so you have to find a cooperative investment banker who is willing to work with you in placing this paper.

There are a host of regulations that must be complied with and that is the responsibility of your tax counsel. There are securities requirements that are the responsibility of your investment banker. By the time we have received our inducement resolution and had two hearings before a city or county, and worked with a New York bond counsel to get an opinion letter that satisfies the county, and then worked with the investment banker to place this instrument some way, a good 6 months have gone by, and probably the expenditure, we find, of approximately $50,000.

Mr. BROWN. I think the intriguing portion of it is that we are not extending that status to anyone who doesn't qualify for it anyway. It is just that we are eliminating the cost of showing that qualification and so we are not changing the perspective in terms of tax status or tax income to the government as much as we are eliminating the requirement to go through that paper work.

Mr. CONABLE. How do you avoid having universities, for instance, act as a front for private institutions?

Mr. OLSON. H.R. 2118 limits the simplification procedure only to those financial instruments that are financing scientific equipment for a college or university. It would still require someone to review the documents and say these do meet the requirements of H.R. 2118, but that is a much simpler procedure than the host of regulations we have to look at today.

Mr. **Conable**. It might have the effect, of course, of transferring a lot of research to universities from other nonprofit research institutions or foundations. Maybe that is a desirable thing, I don't know.

Mr. **Olson**. It would certainly assist universities in acquiring the equipment they need to do state-of-the-art research.

Mr. **Conable**. Thank you. It is an interesting idea.

Mr. **Olson**. Thank you.

Mr. **Downey** [presiding]. I don't have any questions. I will just call the next panel.

Mr. **Conable**. Thank you, Hank.

Mr. **Brown**. Thank you.

Mr. **Downey**. The next panel, John Ritchie, Wallace Ford, Wayne Millsap, Roger Kormendi, and Bernard Tetreault.

You will forgive me if I laugh periodically. It has nothing to do with your testimony. It is just the whispering of my colleagues to my left that engage me.

Mr. **Ritchie**. We would like——

Mr. **Conable**. We want you to be prepared for leadership.

Mr. **Downey**. Mr. Ritchie.

STATEMENT OF JOHN RITCHIE, PRESIDENT, COUNCIL OF STATE HOUSING AGENCIES, AND EXECUTIVE DIRECTOR, VIRGINIA HOUSING DEVELOPMENT AUTHORITY

Mr. **Ritchie**. Thank you, Mr. Chairman. It is a pleasure to be here today. I am the president of the Council of State Housing Agencies and director of the Virginia Housing Development Authority. I want to particularly thank the chairman and Congressman Frenzel for the interest and attention which they have devoted to this issue and for their sponsorship of H.R. 1176.

I would also like to thank Congressman Conable for the attention that he has given this issue not only this year but previously when the Ullman bill was under review.

I request that the prepared statement that I submitted be placed in the record and I will make just a few informal comments. Also, I understand that Mr. Tetreault has been delayed and may not arrive in time for this hearing. I would ask that if he does not arrive, that his prepared statement also be placed in the record.

Mr. **Downey**. Without objection, so ordered. We will put Mr. Tetreault's statement in the record or put him in another panel.

Mr. **Ritchie**. Also, we have a response by CSHA to the GAO report.

Mr. **Downey**. Without objection, that report will appear right behind your prepared statement.

Mr. **Ritchie**. Thank you, Mr. Chairman.

The Virginia Housing Authority was created by our general assembly after a 2-year study of housing conditions in the State and a determination that there was a severe shortage of housing for low- and moderate-income families.

The Housing Finance Agencies was created as one tool to meet this shortage. That was in the early 1970's. Since that time, when many housing finance agencies were created, we have been able to finance over 1 million housing units. Half of these units or 500,000 units have been home ownership units provided by State housing finance agencies.

We have a chart over here which illustrates the persons who have been served by these home ownership units.

Mr. DOWNEY. Could you bring that chart a little closer, please, so we can see it.

Mr. RITCHIE. You will notice from 1978 to 1981 half of the borrowers had incomes less than the median income. In 1982, incomes of borrowers increased significantly. This was because of the significant increase in interest rates which occurred in 1982. This is particularly important when you consider the GAO report which took this period 1982 as the typical year, and generalized its conclusions on the basis of that. This is one of the reasons for the numerous erroneous conclusions in the GAO report.

To give you just a little more perspective on who these home buyers are, I would like to read an excerpt from a letter we received from one of the home buyers.

> Without this program, I would not have been able to buy my home. I am a young, divorced woman with a 9-year-old daughter and after paying rent over 4 years, I realized how many ways an investment would help me for the future. I obtained my loan through Virginia Housing at 8¼ percent in September 1978. Even then I could not handle the conventional mortgage rates and today rates are unreal. Owning my home has been an increased sense of self-worth, confidence and pride in myself and my property. Without Virginia Housing, myself and others like myself and young marrieds starting out may never have had the opportunity I have had.

That gives you a flavor beyond just the numbers. In our last annual report, we put on the cover, a picture of a typical couple whose home was financed with mortgage revenue bonds. The wife has a clerical position, the husband is a lab technician, their income is in the low $20,000's. They have two children, the oldest of which is just entering elementary school, and is in a gifted child program.

They are young, upwardly mobile people who bought a home at $41,000. Our average sale price in Virginia is about $45,000. This provides them, just as Congressman AuCoin suggested, a stake in their community, a stake from which their community will benefit, through the entire lifetime of this young family.

Looking at the sales prices of the homes that are provided with these programs, we have another chart. I would ask Mr. White, if he would, to display that chart. You will see on this chart that from 1978 to 1982, approximately half the homes financed by State programs sold for less than two-thirds of the national median income sales price. These are modestly priced homes.

You will also note that even in 1982, there was no significant increase in the price of a home. What occurred was the families who could afford them were simply restricted because of higher interest rates. In other words, the home-buying population decreased but the homes they were buying, typically three bedrooms, bath and a half, 900 to 1,000 square feet, are the same homes that were being purchased before.

Let me briefly make a few other summary statements. First, these agencies serve as a magnet for capital, bringing capital into capital-poor States and capital-poor areas of States. It also brings capital into inner cities and rural areas where it would not be available otherwise.

It is particularly important to have this instrument of providing home ownership at a time when the Federal Government is withdrawing its support for housing.

With regard to the GAO report, the GAO report can only accurately be summarized as an advocacy document, not an objective analysis.

To mention just a few points, the suggestion that GAO makes that three out of four of our home buyers financed by MRB's with incomes over $20,000 could have afforded conventional loans for their homes defies all of our experience in 1982. We know in 1982 that only 15 percent of the families in America could afford homes. Certainly, if three out of four with incomes over $20,000 had been able to afford them with conventional financing, we would not have had the housing crisis that existed at that time.

Let me also strongly note our objection to the estimates that GAO has made as to the cost of this program.

You can change your estimates of the cost with your assumptions and the assumptions GAO used are the worse possible assumptions which exaggerate the tax loss and understate the tax benefit.

With regard to HUD's testimony yesterday, HUD and ourselves used to be in the same business of serving low- and moderate-income families, sometimes I wonder about that today.

But let me say that the HUD suggestion that this program which would involve by the Joint Tax Committee estimates only a net loss of one-tenth of 1 percent of the estimated deficit will threaten the recovery of the nation, I think, is extremely exaggerated.

Also, to suggest that the need for the program has been eliminated at a time when three-quarters of the families in America can still not afford conventional financing to buy their homes, and at a time when even more importantly, 90 percent of the rental households in America cannot afford conventional financing to buy their homes seems to me to be exaggerated testimony.

In conclusion, Mr. Chairman, let me say that we face in the next 10 years the largest need for home ownership, by first-time home buyers. With the baby boom generation growing up, we will see the largest demand for housing in the history of this Nation. Finally, those who know us best, the Governors, the State legislators, the mayors, the builders, the realtors, are all here testifying in support of this program. They have seen this program, they know it works. That speaks well. Thank you.

[The prepared statement follows:]

STATEMENT OF JOHN RITCHIE, PRESIDENT, COUNCIL OF STATE HOUSING AGENCIES

MR. CHAIRMAN, MEMBERS OF THE COMMITTEE, MY NAME IS JOHN RITCHIE. I AM THE EXECUTIVE DIRECTOR OF THE VIRGINIA HOUSING DEVELOPMENT AUTHORITY, BUT I SPEAK TO YOU TODAY AS PRESIDENT OF THE COUNCIL OF STATE HOUSING AGENCIES, AN ORGANIZATION WHICH REPRESENTS STATE HOUSING FINANCE AGENCIES IN 49 STATES, THE DISTRICT OF COLUMBIA, PUERTO RICO AND THE VIRGIN ISLANDS.

ON BEHALF OF THE COUNCIL, I WANT TO THANK CONGRESSMAN DOWNEY AND CONGRESSMAN FRENZEL FOR THEIR CONTINUING INTEREST IN AND SUPPORT FOR THE WORK OF HOUSING FINANCE AGENCIES. WE GREATLY APPRECIATE THEIR LEADERSHIP IN INTRODUCING H.R. 1176, WHICH WOULD ELIMINATE THE 1983 SUNSET ON TAX-EXEMPT FINANCING FOR HOMEOWNERSHIP.

I AM GRATEFUL FOR THE OPPORTUNITY TO PRESENT TO YOU TODAY THE VIEWS OF THE STATE AGENCIES THAT OPERATE THE HOMEOWNERSHIP PROGRAMS WHICH ARE THREATENED BY THE SUNSET. TO THIS END, I WILL PROVIDE A BRIEF DESCRIPTION OF STATE HOUSING FINANCE AGENCIES AND

INDICATE THE KINDS OF PROGRAMS WE USE TO ALLOW YOUNG FAMILIES TO REALIZE THEIR DREAMS OF HOMEOWNERSHIP, PROGRAMS THAT WOULD BE ELIMINATED IF THE SUNSET WAS ALLOWED TO GO INTO EFFECT. THEN I WILL ADDRESS A NUMBER OF THE QUESTIONS AND ISSUES THAT COME UP TIME AND AGAIN IN THE DISCUSSION OVER MORTGAGE REVENUE BONDS.

STATE HOUSING FINANCE AGENCIES

MORTGAGE REVENUE BONDS ARE ISSUED UNDER THE AUTHORITY OF HOUSING FINANCE AGENCIES ESTABLISHED BY STATE AND LOCAL GOVERNMENTS. ALTHOUGH MANY FOCUS ON 1978 AS THE STARTING POINT FOR BOND PROGRAMS, STATE AGENCIES HAVE BEEN ACTIVE SINCE THE EARLY 70s.

BY 1971, SEVEN STATES HAD USED TAX-EXEMPT BONDS TO FINANCE HOMEOWNERSHIP PROGRAMS AND BY 1975, SPECIFICALLY ENCOURAGED BY CONGRESS IN THE HOUSING AND COMMUNITY DEVELOPMENT ACT OF 1974, LEGISLATION HAD BEEN ENACTED IN 36 STATES TO CREATE STATE HOUSING FINANCE AGENCIES. THUS, STATE AGENCY PROGRAMS ARE LONG ESTABLISHED AND WELL ACCEPTED — THE CENTERPIECE OF HOUSING POLICY IN MANY STATES.

IN SIMPLEST FORM, HOUSING FINANCE AGENCIES SELL TAX-EXEMPT BONDS TO OBTAIN LOW COST MORTGAGE MONEY, WHICH THEY IN TURN LEND TO ELIGIBLE BORROWERS. WITH SINGLE FAMILY MORTGAGE PROGRAMS HFAs LEND TO ELIGIBLE HOMEBUYERS, PRIMARILY FIRST-TIME BUYERS. SOME LEND TO CURRENT HOMEOWNERS WHO WISH TO MAKE IMPROVEMENTS, SUCH AS FOR ENERGY EFFICIENCY. MANY AGENCIES ALSO LEND TO DEVELOPERS OF RENTAL HOUSING, OFTEN IN CONJUNCTION WITH DEPARTMENT OF HOUSING AND URBAN

DEVELOPMENT PROGRAMS. HUD PROGRAMS HAVE DEPENDED HEAVILY ON STATE AGENCIES TO USE FEDERAL DOLLARS TO PRODUCE DECENT, WELL MANAGED, LOW AND MODERATE INCOME HOUSING.

COLLECTIVELY, STATE HOUSING AGENCIES HAVE FINANCED NEARLY ONE MILLION HOUSING UNITS, ABOUT HALF FOR HOMEBUYERS AND HALF RENTAL HOUSING UNITS. THE IMPORTANCE OF THESE AGENCIES TO FEDERAL HOUSING ASSISTANCE EFFORTS IS ILLUSTRATED BY THE FACT THAT ABOUT ONE-THIRD OF THE UNITS CONSTRUCTED UNDER THE SECTION 8 RENT SUBSIDY PROGRAM WERE FINANCED BY STATE HOUSING FINANCE AGENCIES.

HOUSING FINANCE AGENCY PROGRAMS ALSO REFLECT STATE AND LOCAL NEEDS AND PRIORITIES THROUGH PROGRAMS TARGETED TO SPECIAL NEEDS. MANY AGENCIES OPERATE HOME IMPROVEMENT PROGRAMS, PROGRAMS FOR THE ELDERLY AND THE HANDICAPPED, VETERANS' LOAN PROGRAMS, AND SPECIALIZED RURAL OR URBAN REVITALIZATION PROGRAMS.

IT IS PRECISELY THIS VARIETY THAT MAKES STATE AGENCIES SO EFFECTIVE. PROGRAMS THAT MIGHT BE APPROPRIATE FOR VIRGINIA MIGHT NOT HAVE MUCH RELEVANCE FOR YOUR STATES, AND VICE VERSA. AS CONGRESS HAS RECONGIZED INCREASINGLY IN RECENT YEARS, STATE AGENCIES CAN EVALUATE AND RESPOND QUICKLY TO THE NEEDS OF SPECIFIC HOUSING MARKETS FAR BETTER THAN A SINGLE FEDERAL AGENCY MAKING NATIONAL POLICY FROM WASHINGTON.

DESPITE THEIR DIFFERENCES, STATE HOUSING FINANCE AGENCIES HAVE IN COMMON A UNIQUE BLEND OF PUBLIC PURPOSE AND PRIVATE SECTOR DISCIPLINE IN THE DELIVERY OF HOUSING ASSISTANCE. THEY DRAW UPON THE RESOURCES OF PRIVATE INVESTORS, LENDING INSTITUTIONS, BUILDERS AND

DEVELOPERS, RESULTING IN EFFICIENCY THAT IS UNPARALLELED IN OTHER HOUSING ASSISTANCE PROGRAMS. AT THE SAME TIME, THEY SERVE AN IMPORTANT PUBLIC PURPOSE BY PROVIDING ASSISTANCE TO HOUSEHOLDS THAT CANNOT AFFORD MARKET PRICES, BUT MAY ALSO BE EXCLUDED FROM FEDERAL LOW-INCOME HOUSING PROGRAMS. IT IS THIS PRIVATE-PUBLIC LINK THAT HAS MADE HOUSING FINANCE AGENCIES SUCH AN EFFECTIVE FORCE OVER THE PAST DECADE AND THAT PROMISES THEIR VALUE IN THE FUTURE.

MORTGAGE REVENUE BOND PROGRAMS

THE CURRENT DEBATE OVER MORTAGE REVENUE BONDS REVOLVES AROUND THE USE OF TAX-EXEMPT FINANCING FOR OWNER-OCCUPIED HOMES. THIS INCLUDES ANY LOAN TO A FAMILY TO BUY, REHABILITATE OR IMPROVE ITS PRINCIPAL PLACE OF RESIDENCE. AT ISSUE IS THE PROVISION OF THE MORTGAGE SUBSIDY BOND TAX ACT OF 1980 TO END THE TAX EXEMPTION ON BONDS FOR THESE PURPOSES AFTER DECEMBER 31, 1983.

THE PURPOSE OF THE SUNSET DATE IS NOT TO KILL THE PROGRAM, BUT RATHER TO FORCE A REVIEW. I AM CONFIDENT THAT AS YOU SEE THE PERFORMANCE AND ACCOMPLISHMENTS OF MORTGAGE BOND PROGRAMS, YOU WILL FIND THEIR CONTINUATION BOTH NECESSARY AND DESIRABLE.

IT IS IMPORTANT TO APPRECIATE THE CONTEXT IN WHICH YOUR REVIEW OF BOND PROGRAMS TAKES PLACE. WE HAVE NOT HAD A "NORMAL" YEAR SINCE THE ENACTMENT OF THE MORTGAGE SUBSIDY BOND TAX ACT IN LATE 1980. REGULATIONS ISSUED BY THE DEPARTMENT OF TREASURY UNDER THE ACT STOPPED VIRTUALLY ALL NEW HOUSING FINANCE AGENCIES BOND ISSUES UNTIL THE END OF 1981. BY THAT TIME, INTEREST RATES WERE AT RECORD HIGH

LEVELS AND AGENCIES WERE FORCED TO LEND AT RELATIVELY HIGH RATES, RATHER THAN WITHDRAW FROM THE HOUSING MARKET WHEN HOMEBUYERS AND SELLERS NEEDED THEIR ASSISTANCE THE MOST.

AS A RESULT OF THESE CONDITIONS, AND THE ACTIONS YOU TOOK LAST YEAR TO ALLOW REVENUE BOND PROGRAMS TO PROVIDE EVEN MORE OF A STIMULUS TO A MORIBOND HOUSING MARKET, RECENT EXPERIENCE IS ATYPICAL IN TERMS OF INCOME LEVELS SERVED. TO GET AN ACCURATE PICTURE OF OUR PROGRAMS, THEN, YOU MUST CONSIDER PRE-1981 EXPERIENCE AS WELL. I DO NOT MEAN TO SUGGEST THAT STATE AGENCIES NEED APOLOGIZE FOR OUR RECORD OVER THE PAST TWO YEARS. INDEED, I THINK THE DATA ILLUSTRATES DRAMATICALLY HOW EFFECTIVE WE WERE IN HELPING MODERATE INCOME FAMILIES TO PURCHASE MODESTLY PRICED HOUSING, EVEN IN THE WORST OF TIMES. BUT IN ORDER TO GET A MORE REALISTIC VIEW OF HOW REVENUE BOND PROGRAMS WILL FUNCTION IN THE FUTURE, YOU MUST LOOK AT MORE THAN THE EXPERIENCE OF 1982.

AS SHOWN IN TABLE 1, ABOUT HALF OF THE BORROWERS IN STATE SINGLE FAMILY PROGRAMS FROM 1971 TO 1981 HAD INCOMES LESS THAN 80 TO 85 PERCENT OF THE NATIONAL MEDIAN. THIS TRANSLATES INTO A MEDIAN BORROWER INCOME RANGING FROM $14,700 IN 1978 TO $18,000 IN 1981. AS A RESULT OF HIGH INTEREST RATES IN 1982, THE MEDIAN BORROWER INCOME IN STATE PROGRAMS ROSE TO ABOUT $23,000 OR 96 PERCENT OF THE NATIONAL MEDIAN.

TABLE 1

	Borrower Median Income[1]	National Median Income[2]	Borrower Median as % Of National Median Income
1978	$14,725	$17,640	83%
1979	$15,411	$19,587	79%
1980	$17,794	$21,023	85%
1981	$18,068	$22,388	81%
1982	$23,243	$24,200	96%

A RECENT GENERAL ACCOUNTING OFFICE STUDY OF LENDING ACTIVITY IN THE FIRST THREE QUARTERS OF 1982 FOUND THAT JUST OVER HALF OF THE BORROWERS IN MORTGAGE BOND PROGRAMS HAD INCOMES ABOVE THE MEDIAN IN THEIR STATE. IN 1981, HOWEVER, JUST OVER A QUARTER OF HOMEBUYERS IN STATE SINGLE FAMILY PROGRAMS HAD INCOMES ABOVE THE STATE MEDIAN, AND IN 1979, IT WAS LESS THAN 20 PERCENT.

IN SHORT, WHEN INTEREST RATES WERE HIGH IN 1981 AND 1982, IT TOOK A HIGHER INCOME TO AFFORD A LOAN UNDER A MORTGAGE BOND PROGRAM THAN IT HAD IN THE PAST. BUT AT THE SAME TIME, THE PROPORTION OF FAMILIES PRICED OUT OF THE CONVENTIONAL MORTGAGE MARKET HAD GROWN AS WELL, SO THAT ONLY ABOUT 15 PERCENT OF AMERICANS COULD AFFORD TO BUY THE AVERAGE HOME. BOND PROGRAMS, THEREFORE, CONTINUED TO SERVE THEIR TRADITIONAL PURPOSE OF HELPING FAMILIES THAT OTHERWISE COULD NOT AFFORD TO BUY.

1/ Source: Council of State Housing Agencies membership survey; 24 states reporting.

2/ Source: Department of Housing and Urban Development (derived from Bureau of Census data).

THE RECENT GAO REPORT CLAIMS THAT THREE QUARTERS OF THE BORROWERS IT STUDIED "HAD INCOMES ABOVE $20,000 AND COULD LIKELY HAVE PURCHASED ANYWAY." THIS ASSERTION IS CONTRARY BOTH TO LOGIC AND EXPERIENCE.

TABLE 2

HOUSING AFFORDABILITY
(1982)

		Sales Prices	
	Average MRB Financed Home: $48,000[1]	Median Sales Price for Existing Homes: $67,800	124% of Median Sales Price: $84,750
Income Need to Afford Home at 15.5 Percent[2]	$27,501	$38,209	$47,761
Percent of National Median Income[3]	114%	158%	197%

AS TABLE 2 SHOWS, MOST AMERICAN FAMILIES WERE PRICED OUT OF THE MARKET IN 1982. AT MID-YEAR FHA RATES, A FAMILY WOULD HAVE NEEDED AN INCOME OF $38,000 TO AFFORD THE MEDIAN PRICED HOME. THE EFFECT OF HIGH INTEREST RATES CAN BE SEEN CLEARLY IN THE DISMAL RECORD OF HOME SALES AND HOUSING STARTS IN 1982. YET GAO CONCLUDES THAT BUYERS HAD AMPLE OPPORTUNITY TO FINANCE HOMES IN 1982 WITHOUT THE REDUCED RATES FROM MORTGAGE REVENUE BONDS.

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[1] Average sales price on MRB homes financed during first three quarters of 1982, according to GAO.

[2] Assuming 90% mortgage, 30-year term, ratio of principal and inteest payment to gross income equaling 25%; 15.5% was med-year FHA rate.

[3] $24,200.

IN DRAWING THIS CONCLUSION, GAO PRESUMES TO KNOW WHAT BORROWERS COULD HAVE AND WOULD HAVE DONE IN THE ABSENCE OF THE MORTGAGE REVENUE BOND SUBSIDY. IT PRESUMES THAT BORROWERS HAD ACCESS TO LOANS FROM PRIVATE LENDERS AT 15.5 PERCENT INTEREST, AT TERMS THAT THEY COULD STILL AFFORD. IT ALSO PRESUMES THAT BORROWERS DID NOT HAVE OTHER OBLIGATIONS, SUCH AS CAR PAYMENTS OR STUDENT LOANS, THAT WOULD HAVE PREVENTED THEM FROM QUALIFYING FOR THE SAME MORTGAGE AT HIGHER RATES. AND FINALLY, IT PRESUMES THAT BUYERS WOULD STILL BE WILLING TO BUY AT THIS HIGHER RATE AND PERHAPS ALSO ACCEPT AN ADJUSTABLE RATE MORTGAGE.

ACTUAL EXPERIENCE IN 1982 SHOWED THAT THE HOME PURCHASE OPPORTUNITIES PRESUMED TO BE AVAILABLE TO BORROWERS BY GAO WERE, IN FACT, NOT AVAILABLE. REGARDLESS OF WHAT WAS THEORETICALLY POSSIBLE, POTENTIAL HOMEBUYERS WERE BOTH UNABLE TO AFFORD THE TERMS OFFERED BY PRIVATE LENDERS IN 1982 AND LARGELY UNWILLING TO ACCEPT ALTERNATIVE MORTGAGE INSTRUMENTS SUCH AS GRADUATED PAYMENT MORTGAGES. BOND PROGRAM MORTGAGES FILLED A ROLE THAT OTHER SOURCES OF CAPITAL COULD NOT.

THE COST OF HOMES FINANCED THROUGH BOND PROGRAMS ILLUSTRATES THE SUCCESS THAT THEY HAVE HAD IN TARGETING BENEFITS. AS TABLE 3 SHOWS, THE MEDIAN HOME FINANCED BY STATE AGENCY PROGRAMS HAS SOLD FROM 1978 THROUGH 1982 FOR LESS THAN TWO THIRDS OF THE NATIONAL MEDIAN SALES PRICE. GAO FOUND AN AVERAGE SALES PRICE FOR HOMES FINANCED BY MORTGAGE BONDS OF $48,800, COMPARED WITH A NATIONAL AVERAGE SALES PRICE OF ABOUT $80,100 IN 1982.

TABLE 3

	MRB Median Sales Price[1]	National Median Sales Price[2]	MRB Median as % of National
1978	$35,866	$55,700	64%
1979	$37,515	$62,900	59%
1980	$42,438	$64,600	66%
1981	$43,233	$68,900	63%
1982	$43,791	$69,300	63%

THUS, WHILE SOME CRITICS CHARGE THAT TAX EXEMPT FINANCING ALLOWS FAMILIES TO BUY MORE EXPENSIVE HOMES THAN THEY OTHERWISE WOULD, THE FACTS SHOW THAT "MORE EXPENSIVE" DOES NOT MEAN HIGH COST. THE DATA SHOWS THAT BORROWERS IN MORTGAGE REVENUE BOND PROGRAMS GENERALLY BUY MODESTLY PRICED HOMES. IF THESE HOMES ARE MORE COSTLY THAN THE BORROWERS OTHERWISE COULD HAVE AFFORDED, IT IS LIKELY THAT THEY COULD NOT OR WOULD NOT HAVE BOUGHT AT ALL.

FINALLY, BEFORE TURNING TO THE POLICY QUESTIONS, I WANT TO POINT OUT THAT HOME PURCHASE PROGRAMS ARE NOT ALL THAT WILL BE LOST IF THE "SUNSET" IS NOT STOPPED. MANY STATES AND LOCALITIES USE THESE BONDS TO FINANCE HOME IMPROVEMENT, ENERGY CONSERVATION AND REHABILITATION PROGRAMS. THESE PROGRAMS ARE OFTEN SUBSIDIZED BY STATE CONTRIBUTIONS OR COMMUNITY DEVELOPMENT BLOCK GRANTS, WHICH REDUCE INTEREST RATES TO A LEVEL AFFORDABLE TO LOW INCOME

1/ Source: Council of State Housing Agencies membership survey; 24 states reporting.

2/ Source: Department of Housing and Urban Development (derived from Bureau of Census data).

HOMEOWNERS. THESE PROVIDE AN IMPORTANT COMPLEMENT TO FIRST MORTGAGE LOAN PROGRAMS IN MANY STATES.

MAJOR POLICY QUESTIONS

THE DEBATE OVER MORTGAGE REVENUE BONDS COVERS MANY ISSUES, BUT GENERALY BOILS DOWN TO SIX MAJOR POLICY QUESTIONS. THE FIRST AND MOST BASIC OF THESE IS WHETHER THERE IS A NEED FOR THE KIND OF ASSISTANCE PROVIDED BY MORTGAGE BONDS. IN TESTIMONY LAST MONTH, ASSISTANT TREASURY SECRETARY JOHN CHAPOTON STATED THE BELIEF "THAT FEDERAL SUPPORT FOR OWNER-OCCUPIED HOUSING FOR LOW- AND MODERATE-INCOME FAMILIES IS SUFFICIENT WITHOUT MORTGAGE SUBSIDY BONDS." BY THIS, HE WAS EVIDENTLY REFERRING TO TAX DEDUCTIONS FOR HOMEOWNERS AND FHA MORTGAGE INSURANCE.

IT HAS BEEN WELL ESTABLISHED, HOWEVER, THAT TAX DEDUCTIONS FOR MORTGAGE INTEREST AND PROPERTY TAX PAYMENTS OVERWHELMINGLY BENEFIT HIGHER INCOME HOMEOWNERS. LAST FALL, A TREASURY DEPARTMENT ESTIMATE SHOWED THAT 75 PERCENT OF THE REVENUE LOSS RESULTING FROM THESE DEDUCTIONS GOES TO TAXPAYERS WITH INCOMES OVER $30,000. YET, EVEN IN 1982, THE GREAT MAJORITY OF BORROWERS IN MORTGAGE BOND PROGRAMS HAD INCOMES BELOW THIS LEVEL. CLEARLY, THE AMOUNT OF OVERLAP BETWEEN THE TWO IS LIMITED.

AS FOR FHA MORTGAGE INSURANCE, THE EVIDENCE IS THAT TAX-EXEMPT FINANCING ALLOWS MORTGAGE BOND PROGRAMS TO REACH A SIGNIFICANTLY LOWER INCOME GROUP THAN THOSE BORROWING WITH FHA UNSUBSIDIZED MORTGAGE INSURANCE. IN 1982, ABOUT HALF OF THE BORROWERS IN

MORTGAGE BOND PROGRAMS HAD INCOMES LESS THAN $23,000, WHICH IS ABOUT $10,000 BELOW THE MEDIAN FOR FHA BORROWERS. MOREOVER, THE TWO PROGRAMS SERVE DIFFERENT PURPOSES; MORTGAGE REVENUE BONDS INCREASE THE SUPPLY OF MORTGAGE CAPITAL AVAILABLE TO LOWER INCOME HOMEBUYERS, WHEREAS FHA INSURANCE PROVIDES SECURITY FOR A LENDER WHERE MORTGAGE WITH CAPITAL IS AVAILABLE. FURTHER, FHA INSURANCE IS NOT TARGETED TO FIRST-TIME HOMEBUYERS. IN SUM, MORTGAGE BOND FINANCING PROVIDES HIGHLY TARGETED BENEFITS TO A LOWER INCOME GROUP OF FIRST-TIME HOMEBUYERS THAN IS NORMALLY SERVED BY FHA.

A SECOND QUESTION POSED IS THAT OF WHO OUGHT TO BENEFIT FROM MORTGAGE REVENUE BONDS. WHEN GAO CRITICIZES MORTGAGE BOND PROGRAMS FOR NOT ADEQUATELY SERVING LOW AND MODERATE INCOME HOMEBUYERS, IT ASSUMES ITS OWN DEFINITION OF WHO OUGHT TO BE SERVED. GAO DEFINES THE INTENDED BENEFICIARIES OF THESE PROGRAMS AS "LOW AND MODERATE INCOME" OR LESS THAN 80 PERCENT OF MEDIAN (ALTHOUGH IT SHOULD BE NOTED THAT EARLIER GAO STUDIES HAVE USED A MORE LIBERAL DEFINITION OF LOW AND MODERATE INCOME FOR HOMEOWNERSHIP PROGRAMS).

THIS DEFINITION HAS NO BASIS IN FEDERAL LAW OR EXPERIENCE AND DOES NOT REFLECT THE GOALS ESTABLISHED BY THOSE OPERATING THE PROGRAMS. OVERWHELMING, STATE AND LOCAL GOVERNMENTS HAVE ESTABLISHED THAT THE PURPOSE OF THESE PROGRAMS IS TO FILL AN AFFORDABILITY GAP, SERVING THOSE FAMILIES WHO FIND THEMSELVES PRICED OUT OF THE HOMEOWNERSHIP MARKET. DEFINING THIS GROUP IS A DIFFICULT TASK, BECAUSE THE ABILITY TO AFFORD HOMEOWNERSHIP DEPENDS ON BOTH INCOME PRICE AND INTEREST RATES. A DEFINITION BASED STRICTLY ON INCOME, SUCH

AS THAT USED BY GAO, MAY BE A POOR MEASURE OF WHO ACTUALLY IS PRICED OUT OF THE MARKET. THIS IS CERTAINLY THE CASE IN PERIODS WHEN THE COST OF BUYING IS ABNORMALLY HIGH, AS IT WAS DURING 1981 AND 1982.

FEDERAL HOUSING LAWS CONTRADICT GAO'S ASSUMPTION. THE SECTION 8 AND PUBLIC HOUSING PROGRAMS PROVIDE LARGE RENTAL SUBSIDIES FOR HOUSEHOLDS WITH INCOMES UP TO 80 PERCENT OF MEDIAN. THE SECTION 235 HOMEOWNERSHIP PROGRAM SUBSIDIZED INTEREST RATES DOWN TO 1 OR 6 PERCENT FOR HOUSEHOLDS AT 95 PERCENT OF MEDIAN. COMPARED TO THESE PROGRAMS AND THE TOTAL COST OF BUYING A HOME, THE INTEREST RATE REDUCTION PROVIDED BY TAX-EXEMPT FINANCING IS A RELATIVELY SMALL SUBSIDY. AS A RESULT, WE GENERALLY REACH FAMILIES THAT ARE CLOSER TO BEING ABLE TO AFFORD HOMEOWNERSHIP. CONVERSELY, GIVEN THE COST OF HOUSING AND THE COST OF FINANCING, VERY LOW INCOME FAMILIES ARE EFFECTIVELY EXCLUDED FROM BUYING A HOME TODAY UNDER MORTGAGE REVENUE BOND PROGRAMS WITHOUT SUBSTANTIAL ADDITIONAL SUBSIDY.

THE COST OF MORTGAGE REVENUE BONDS IS ANOTHER CRITICAL ISSUE. THE JOINT COMMITTEE ON TAXATION HAS ESTIMATED THAT CONTINUING THE TAX EXEMPTION ON MORTGAGE REVENUE BONDS WILL COST ABOUT $2.1 BILLION THROUGH FISCAL YEAR 1988. ON AN ANNUAL BASIS, THIS REPRESENTS ABOUT $21 MILLION PER $1 BILLION IN MORTGAGE REVENUE BONDS ISSUED, OR ROUGHLY $1,000 PER HOME.

ACTUALLY, NO ONE KNOWS EXACTLY HOW MUCH THE TREASURY LOSES WHEN NEW TAX-EXEMPT BONDS ARE ISSUED. DIFFERENT ECONOMISTS HAVE DIFFERENT METHODS FOR ESTIMATING THE TAX LOSS RESULTING FROM THESE BONDS, EACH BASED UPON PREDICTIONS OF HOW PEOPLE WILL ACT WHEN

FACED WITH NEW TAX-EXEMPT INVESTMENT OPPORTUNITIES. PROFESSOR ROGER KORMENDI OF THE UNIVERSITY OF CHICAGO WILL SPEAK LATER AND EXPLAIN A METHOD OF ESTIMATING TAX REVENUE LOSS THAT DIFFERS FROM THE JOINT COMMITTEE AND TREASURY ESTIMATES. USING THIS METHOD, WHICH INCORPORATES A MORE REALISTIC VIEW OF THE WAY INVESTORS ACTUALLY BEHAVE, PROFESSOR KORMENDI ARRIVES AT ESTIMATES BETWEEN A THIRD AND A HALF THE SIZE OF THOSE PUT FORTH BY TREASURY AND THE JOINT COMMITTEE.

ANOTHER ASPECT THAT SHOULD BE TAKEN INTO ACCOUNT WHEN ESTIMATING THE COST OF MORTGAGE REVENUE BONDS IS THEIR POTENTIAL FOR CREATING NEW SAVINGS. MOST METHODS OF ESTMATING REVENUE LOSS ASSUME THAT THE INVESTOR WHO BUYS A NEW TAX-EXEMPT BOND WILL SELL ANOTHER ASSET TO FINANCE THAT PURCHASE. THE ASSUMPTION IS THAT THIS OTHER ASSET GENERATED TAX REVENUE FOR THE FEDERAL GOVERNMENT; HENCE, THE REVENUE LOSS WHEN IT IS SOLD. THIS DOES NOT CONSIDER, HOWEVER, THE INVESTOR WHO BUYS A TAX-EXEMPT BOND WITH NEW SAVINGS. TO THE EXTENT THIS OCCURS, THERE WOULD BE NO REVENUE LOSS. IN FACT, THERE MAY BE A REVENUE GAIN COMING FROM NEW ECONOMIC ACTIVITY RESULTING FROM INVESTMENT OF THIS SAVINGS.

IN SHORT, REVENUE LOSSES FROM MORTGAGE BONDS ARE A MATTER OF SUBSTANTIAL DISPUTE BETWEEN ANALYSTS, AND LIKELY FALL WELL BELOW THOSE PROJECTED BY THE TREASURY DEPARTMENT.

ALONG WITH QUESTIONS OF COST, IT IS SUGGESTED THAT MORTGAGE REVENUE BONDS HAVE AN ADVERSE EFFECT ON THE MUNICIPAL BOND MARKET. THE VOLUME OF TAX-EXEMPT BORROWING IS JUST ONE OF MANY

FACTORS THAT AFFECT INTEREST RATES IN THE MUNICIPAL BOND MARKET. IN RECENT YEARS, THE SUPPLY OF NEW ISSUES HAS HAD AN EFFECT FAR LESS SIGNIFICANT THAN FACTORS INFLUENCING THE DEMAND FOR TAX-EXEMPT INVESTMENTS, SUCH AS TAX CUTS, POOR PROFITABILITY ON THE PART OF INSTITUTIONAL INVESTORS, AND COMPETITION FROM FEDERAL BORROWING.

NEVERTHELESS, PROPONENTS OF THIS ARGUMENT ARE OFTEN UNABLE TO RESIST THE TEMPTATION TO MAGNIFY THE IMPACT OF MORTGAGE BONDS. THUS, IN HIS TESTIMONY TO A SENATE FINANCE SUBCOMMITTEE, ASSISTANT SECRETARY CHAPOTON STATED THAT "MORTGAGE SUBSIDY BONDS WILL INCREASE THE TOTAL FUTURE INTEREST PAYMENTS ON PUBLIC PURPOSE BONDS ISSUED IN 1982 BY AT LEAST $2 BILLION." DISCOUNTED TO PRESENT VALUE, THAT COST WOULD ACTUALLY BE LESS THAN $1 BILLION. MORE IMPORTANTLY, COST WOULD BE SPREAD AMONG MANY ISSUERS OVER 25 TO 40 YEARS AND WOULD BE A SMALL FRACTION OF THE ROUGHLY $90 BILLION THAT THEY WOULD PAY IN TOTAL INTEREST COSTS.

PERHAPS MOST IMPORTANTLY, IT SHOULD BE RECONGNIZED THAT THE VOLUME OF MORTGAGE REVENUE BONDS ISSUED IS CAPPED BY FEDERAL LAW AND CONSTRAINED BY OTHER RESTRICTIONS OF THE MORTGAGE SUBSIDY BOND TAX ACT. THUS, UNLIKE OTHER BOND ISSUES AND UNLIKE THE RANGE OF FACTORS THAT CAN AFFECT THE MUNICIPAL MARKET, MORTGAGE BOND VOLUME IS A KNOWN, CONTROLLED QUANTITY.

IT IS SOMETIMES ASSERTED THAT THE SAME BENEFITS WHICH BOND PROGRAMS PROVIDE COULD BE PROVIDED AT LESS COST THROUGH A DIRECT FEDERAL SUBSIDY. THE GAO REPORT ASSERTS, FOR EXAMPLE, THAT DIRECT SUBSIDY PROGRAMS WOULD COST SUBSTANTIALLY LESS THAN WHAT IT COSTS

TO SUBSIDIZE HOMEOWNERSHIP THROUGH MORTGAGE REVENUE BONDS. WE HAVE ANALYZED THE GAO ASSERTION AND PROVIDED A DETAILED REFUTION OF IT IN OUR RESPONSE TO THE GAO PRELIMINARY REPORT, WHICH HAS BEEN PROVIDED TO THE MEMBERS OF THIS COMMITTEE. WHILE I WILL NOT REITERATE THE ANALYSIS HERE, I WOULD NOTE THAT GAO'S CLAIM IS BASED ON A SERIES OF INVALID ASSUMPTIONS AND THAT A MORE REALISTIC APPRAISAL SHOWS THE COSTS OF POTENTIAL HOUSING PROGRAMS TO BE ROUGHLY COMPARABLE TO THOSE OF REVENUE BONDS AND TO BE HIGHLY SENSITIVE TO CHANGES IN MARKET CONDITIONS.

MORE IMPORTANTLY, NOBODY TODAY SERIOUSLY BELIEVES THAT CONGRESS WILL ENACT A MAJOR NEW DIRECT SUBSIDY PROGRAM FOR HOMEOWNERSHIP. IF CONGRESS WANTS TO CONTINUE TO PROVIDE ASSISTANCE TO MODERATE INCOME FIRST-TIME HOMEBUYERS, IT IS LIKELY TO COME THROUGH REVENUE BOND PROGRAMS OR NOT AT ALL.

FINALLY, I KNOW YOU ARE CONSIDERING THE QUESTION OF WHETHER, ASSUMING BOND PROGRAMS ARE CONTINUED, THERE SHOULD BE TIGHTER RESTRICTIONS ON THE USE OF THESE BONDS. THE COUNCIL OF STATE HOUSING AGENCIES BELIEVES STRONGLY THAT STATE AND LOCAL GOVERNMENTS HAVE, AS A RULE, OPERATED PROGRAMS RESPONSIBLY AND THAT FURTHER RESTRICTIONS ARE NOT ONLY UNNECESSARY BUT ALSO WOULD PROVE DETRIMENTAL.

ON INCOME LIMITS, FOR EXAMPLE, THE STANDARD SUGGESTED BY GAO OF 80 PERCENT OF MEDIAN WOULD HAVE PREVENTED MORTGAGE REVENUE BOND PROGRAMS FROM OPERATING IN 1982. EVEN A LIMIT OF 120 PERCENT OF MEDIAN WOULD HAVE SEVERLY WEAKENED MARKET ACCEPTANCE OF BONDS IN 1982.

HOUSING FINANCE AGENCIES ARE CONCERNED ABOUT TIGHTER RESTRICTIONS NOT ONLY FOR THE EFFECT THAT THEY WOULD HAVE DURING HIGH COST PERIODS, BUT ALSO BECAUSE OF THE EXPERIENCE THAT WE HAVE HAD IMPLEMENTING THE 1980 RESTRICTIONS. AS A HAVE MENTIONED, THE MORTGAGE SUBSIDY BOND TAX ACT AND SUBSEQUENT REGULATIONS VIRTUALLY PUT US OUT OF BUSINESS FOR A YEAR. THE PROGRAMS HAVE BEEN MADE INFINITELY MORE COMPLICATED BY RULES AND REGULATIONS DESIGNED BY A DEPARTMENT THAT WOULD PREFER TO SEE US NOT OPERATING AT ALL.

IN CONCLUSION, I WOULD STRESS THE UNIQUE NATURE OF THE PROGRAMS THAT YOU ARE CONSIDERING. WHILE THE FEDERAL INTEREST IN TAX EXEMPTION IS CLEAR AND SOME REGULATION OF THE MARKET IS NEEDED, MORTGAGE REVENUE BONDS ARE NOT A FEDERAL PROGRAM. THEY ARE CREATED AND OPERATED BY STATE AND LOCAL GOVERNMENTS, WHICH ARE RESPONSIBLE AND ACCOUNTABLE FOR THEIR PERFORMANCE. THESE PROGRAMS ARE A WELL ESTABLISHED PART OF STATE AND LOCAL HOUSING POLICY, THE POPULARITY OF WHICH IS DEMONSTRATED BY THE LONG LIST OF GROUPS SUPPORTING ELIMINATION OF THE SUNSET AND THE LARGE NUMBER OF YOUR COLLEAGUES WHO HAVE CO-SPONSORED H.R. 1176. WE ASK THAT YOU RECOGNIZE MORTGAGE REVENUE BONDS AS A JOINT FEDERAL, STATE, AND LOCAL INTEREST AND SUPPORT THEIR CONTINUATION.

COUNCIL OF STATE HOUSING AGENCIES

May 12, 1983

COUNCIL OF STATE HOUSING AGENCIES RESPONSE TO THE GENERAL ACCOUNTING OFFICE STUDY "THE COSTS AND BENEFITS OF MORTGAGE REVENUE BONDS: PRELIMINARY REPORT"

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Executive Summary
Council of State Housing Agencies
Response to the GAO Study
"The Cost and Benefits of Single-Family Mortgage Bonds: Preliminary Report"

This analysis was prompted by the GAO report REED-145, April 28, 1983 entitled The Costs and Benefits of Single-Family Mortgages: Preliminary Report. This report was requested by the Chairman of the Senate Finance Committee in order to receive the preliminary findings of a study of mortgage bonds that had been self-initiated by GAO. Although we believe the objective of the study—to review the mortgage bond program in advance of the "sunset" hearings—was potentially useful, the report itself is often inaccurate, misleading and based on incomplete data. To supply a more reasoned, accurate and useful report on the issues associated with the "sunset", this report responds to GAO on an issue by issue basis.

GAO APPROACH

We have two general comments on the GAO's approach to the issues and their presentation:

- GAO chose to limit its investigation to bonds issued from December 1981 through July 1982, a period of record high interest rates. This unrepresentative period distorts the analysis for budget purposes and provides a misleading picture of program beneficiaries. Despite this flaw in its approach, GAO does not attempt to balance its work with a perspective from past years, nor is the role played by State housing agencies in providing capital in 1982 to a severely depressed housing industry put into context.
- GAO presents conclusions which are unsupported by the data. For example, GAO's Figure 1, which compares MRB and FHA homebuyer incomes—however obscurely—is stated to show that incomes in these groups are essentially similar. In fact, the FHA homebuyer has a median income of $10,000 above the State agency buyer and the comparison shows that MRBs have a far greater share of borrowers in the lower income levels.

NOTE ON FUTURE BUDGET PROJECTIONS

The issue of future tax expenditures for post sunset years must be clarified. GAO uses 1982 interest rate assumptions for its cost analyses. Because the estimates of the cost of bond programs are based on overall interest rates, 1982's high rates dramatically—and improperly—inflate the revenue impact of tax-exempt financing, regardless of the methodology used.

In attempting to project tax expenditures for future years, the Joint Committee on Taxation uses reasonable estimates of interest rates for those years. The following chart, based on economic assumptions used by the Joint Committee in projecting revenue losses shows estimates of the cost of tax-exempt financing programs in a more normal year. We believe this to be a more accurate portrayal of the range of costs under all methods, both on a gross and per unit basis.

MORTGAGE REVENUE BONDS:
PROJECTED COSTS(1)
1984

Estimating Method	Revenue Loss Per $1 Billion in MRBs	Cost Per Mortgage Per Year	Total Subsidy Cost Per Mortgage
GAO	$31.5 mil.	$1,568	$8,681
Joint Tax	$22.7 mil.	$1,057	$6,255
Kormendi/Nagle	$7.5 mil.	$349	$2,065

1/ The methodology and sources for the various tables contained in this Executive Summary are set forth in the body of this response.

I. COST/BENEFIT ANALYSIS

1. Cost of Tax-Exempt Financing

Beyond its misleading use of 1982 data, GAO overstates the costs of tax-exempt financing:

- The report estimates the cost of mortgage bond programs based on the traditional method used by the Joint Committee on Taxation. However, it fails to include, as does the Joint Committee, increased revenue resulting from lower tax deductions taken by homebuyers using this financing.

- GAO assumes only 87 percent of the funds raised by bonds will be used for mortgages. Since the 1980 Mortgage Subsidy Bond Tax Act, a 13 percent set-aside tends to be the maximum, not the average.

- Most importantly, GAO fails to acknowledge alternative—and more realistic—explanations of how tax-exempt issues affect federal revenues, such as a University of Chicago (Kormendi/Nagle) model which bases its estimates of revenue loss on actual investor behavior patterns and produces cost estimates substantially below those GAO uses.

The following table summarizes alternatives to the GAO revenue loss estimates, based on 1982 interest rates:

REVENUE LOSS ESTIMATES
(1982 Base)

Method	Cost per $43,000 Mortgage	Cost Per $1 Billion of Bonds
GAO	$13,300	$45 million
GAO (7% set-aside and Joint Committee offset)	$10,155	$36.9 million
Kormendi/Nagle	$5,699	$19.3 million
Kormendi/Nagle (7% set-aside and offset)	$3,231	$11.7 million

Thus, the GAO estimate exceeds other, more plausible estimates of the cost of tax-exempt financing by anywhere from 30 to 400 percent.

2. Benefits to Home Purchasers

As GAO overstates the cost of revenue bond financing, so does it understate the benefit to home purchasers. It does so by understating the conventional mortgage rates and overstating the tax exempt mortgage rates that existed in 1982.

The following table illustrates the costs and benefits of tax-exempt financing using more realistic assumptions:

COSTS AND BENEFITS OF TAX-EXEMPT FINANCING
(1982 Base)

Method	Cost/Unit	Savings to Purchaser
GAO	$13,300	$8,533
GAO (7% set-aside and offset)	$10,155	$8,533
Kormendi/Nagle	$5,699	$8,533
Kormendi/Nagle (7% set-aside and offset)	$3,231	$8,533

3. Cost of Alternative Programs - 1982

GAO compares bond programs with the cost of theoretical alternative homeownership subsidy programs. As with the estimates of the cost of MRBs, more realistic interest rate assumptions greatly change the projected cost of these alternatives:

ALTERNATIVE COST ESTIMATES
(1982 Base)

Program	Cost Per Mortgage: GAO Assumptions	Cost Per Mortgage: Alternative Assumptions
Mortgage Revenue Bonds	$13,300	$5,699
Taxable Bonds	$10,400	$8,835
Mortgage Grants	$3,400	$8,680
Tax Credits	$3,500	$9,112

4. Credit Market Effect of MRBs

GAO states that MRBs drive up the cost of other municipal bond issues. To support this claim, GAO uses figures that overstate the percentage of the market that MRBs held in 1982, which was about 10 percent, not 14 percent, of total issues, and less than 3 percent of total outstanding tax-exempt bonds. Moreover, the volume of MRB issues is capped, so that arguments based upon an expectation of unrestrained growth are no longer relevant.

The volume of tax-exempt bond issues is only one of many factors that affect municipal rates, as market experience has demonstrated. Other factors include the reduction in federal income taxes, the withdrawal of financial institutions from the market because of profitability problems, and competition from other credit users, including the federal government.

5. Policy Considerations

The GAO report focuses on monetary costs and benefits of tax exempt financing. In doing so, it neglects other benefits and advantages which cannot be so easily quantified:

- Local and state agencies can tailor programs to local needs.
- Mortgage bond programs provide a source of mortgage funds to rural and urban areas which are traditionally capital short. They also have been particularly helpful as a tool of urban revitalization and neighborhood improvement.
- Special programs such as home improvement loans are ignored by GAO.
- There is no mention of the importance of these State and local programs in the face of reduced Federal support for housing and for housing program administration.
- GAO ignores the role Congress and the Administration designated for MRBs in 1982 as a countercyclical support for the housing industry.

II. BENEFICIARIES OF REVENUE BOND PROGRAMS

The picture of mortgage bond beneficiaries presented by GAO is distorted, and its conclusions are unsupported by the data it presents or chooses not to present.

1. Use of 1982 Data Misleads

The use of 1982 data is misleading because of high interest rates. Agencies had to go beyond the predominantly lower income homebuyers that they had served in the past in order to keep programs running at a time when the housing market needed support. The following table puts the 1982 experience into historical perspective.

MRB HOMEBUYER INCOMES:
HISTORICAL PERSPECTIVE

Year	1978	1979	1980	1981	1982
MRB Borrower Median Income (State agencies)	$14,725	$15,441	$17,794	$18,068	$23,243
National Median Income	$17,640	$19,587	$21,023	$22,388	$24,200
MRB Borrower as % of National Median	83%	79%	85%	81%	96%

2. Even in 1982, the MRB Program Served the Lowest Segment of the Home Purchase Market

According to GAO, the incomes of the MRB homebuyers "were similar to those of buyers" under the FHA unsubsidized mortgage programs. The actual picture is quite different:

MRB AND FHA HOMEBUYER MEDIAN INCOMES: 1982

FHA 1982 Median Income	$33,166
MRB 1982 Median Income (state agencies)	$23,243
% Difference	43%

What is true for medians is equally true across the board. Fully 50 percent of revenue bond program homebuyers in 1982 had incomes of less than $25,000 compared with only 23 percent of FHA buyers. Only 15 percent of MRB buyers had incomes over $35,000, compared to 41 percent of FHA buyers.

GAO states the "typical mortgage revenue bond homebuyer in 1982" had an income "between $20,000 and $40,000." In fact, the typical buyer had income of less than $25,000 and, as GAO's own data indicates, 72 percent were below $30,000.

GAO states the program serves the "more affluent half of the families in their states." What this means is that during a period of unprecedented high interest rates, nearly half the MRB buyers had incomes below the median income. In fact 23 percent had incomes at or below the eligibility level for the Section 8 "deep subsidy" program.

3. Revenue Bond Program Beneficiaries Could Not Have Purchased Homes Without This Assistance

GAO asserts that "three quarters of buyers had incomes above $20,000" and would have bought in the absence of revenue bond assistance. No data is given to support this conclusion and if it were accurate, the housing industry would not have been paralyzed in 1982.

At the interest rates prevailing for most of the year, it would have taken an income of $38,000 to buy a median priced existing home. Fewer than 10 percent of MRB buyers had incomes at this level. Even at 75 percent of the median priced existing home, fewer than 50 percent of MRB buyers had incomes sufficient to support a mortgage. Thus, the data supports the conclusion dictated by common sense and experience: the moderate income homebuyer served by MRBs would otherwise have been priced out of the market.

4. Further Income Restraints and Purchase Price Limits Are Unnecessary

The experience of 1982 shows clearly that flexibility at the state and local level was essential to the value of mortgage bond programs. Arbitrary income limits would have precluded a countercylical role for MRBs. Thus, experience validated the judgment of Congress in rejecting such limits.

GAO also contends that the purchase price ceiling does not limit, indeed, actually "encourages" participation of "upper income people." This ignores the actual results seen in 1982. GAO in its own sample found the average purchase price to be $48,800—hardly luxury housing. Revenue bond programs helped finance modestly priced housing in 1982, just as they have over the past several years. It simply took more income in 1982 for homebuyers to be able to afford modestly priced housing.

MRB MEDIAN HOME SALES PRICES VS. NATIONAL MEDIAN

	1978	1979	1980	1981	1982
MRB Median Sales Price	$35,866	$37,515	$42,438	$43,233	$43,791
National Median Sales Price	$55,700	$62,900	$64,600	$68,900	$69,300
MRB Median as % of National	64%	59%	66%	63%	63%

5. Federal Policies and State Agency Practices Effectively Target Revenue Bond Benefits.

As GAO acknowledges, Congress intended revenue bonds to serve those households that could not afford to purchase homes without assistance. Despite record high interest rates and the worst housing depression since World War II, State and local bond programs served precisely this function in 1982. As economic conditions continue to improve, their ability to aid the lowest end of the spectrum of first-time homebuyers will grow and their record of achievement should improve even further.

PART I
COST/BENEFIT ANALYSIS

The GAO report attempts to assess the cost effectiveness of mortgage revenue bonds by estimating their cost to the government in terms of lost tax revenues. It then compares that loss, first, with estimates of the financial benefit provided to borrowers and, second, with projected costs of several hypothetical alternative means of providing comparable levels of assistance to first-time homebuyers.

As the following will demonstrate, GAO (1) used an inappropriate methodology to compute the costs of tax-exempt bonds and (2) chose a number of assumptions that were inaccurate, internally inconsistent or otherwise invalid in making its estimates of the benefits of revenue bond programs and the costs of its suggested alternatives. As a result of these faulty assumptions and calucations, the cost/benefit analysis presented in the GAO report cannot withstand serious scrutiny and should not be used by the Congress as a basis for decision making.

It must be emphasized from the outset that this discussion of the cost of homeownership subsidy programs is based on the extreme high interest rates of 1982. Under more normal economic conditions, even the most exaggerated estimates of the cost of tax-exempt financing programs fall dramatically, as shown in section 4 below.

1. Costs of Tax-Exempt Financing

GAO bases its cost estimates on the traditional tax expenditure methodology used by the Department of the Treasury and the Joint Committee on Taxation. This method of estimating Federal revenue losses assumes that an issue of tax exempt bonds "replaces" an equal volume of fully taxable instruments. The taxes lost are computed as those which otherwise would have been collected on the taxable securities.

GAO assumes a taxable security rate of approximately 15 percent* and a marginal tax bracket for security purchasers of 30 percent. Finally, GAO assumes that "only 87 percent of funds raised will be available to lend for home mortgages," thereby requiring $49,770 to be raised for each average mortgage of $43,300. Using these assumptions and methodology, GAO estimates a total revenue loss for the average tax-exempt mortgage in 1982 to be $13,300.

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*Although the taxable instrument rate is not stated in the report, we derive 15 percent from GAO's calculations.

The GAO methodology and assumptions grossly overstate the actual costs of tax-exempt financing for first-time homebuyers. First, the GAO approach, while based on the method used by the Joint Committee on Taxation, varies from it in a critical respect: it fails to include the increased tax revenues that result from lower mortgage interest deductions taken by homebuyers using this financing. Thus, while GAO computes the revenue loss for its hypothetical 1982 mortgage as $13,300, the Joint Committee on Taxation would compute a revenue loss in the same year, for the same size mortgage, as approximately $11,013.*

A second flaw in GAO's analysis is its assumption that no more than 87 percent of the funds raised will be used for mortgages. In fact, many issuers now use well over 90 percent of bond proceeds for home mortgages. Consequently, if GAO had assumed that 93 percent of bond proceeds went to homebuyers, costs under the GAO approach would drop to $12,397. By the Joint Committee method, costs would drop further to $10,155.

Implicit in GAO's estimates of the revenue cost of mortgage bonds is the use of the 30 percent tax bracket from which to calculate tax loss. Some may argue that this is too low, given the fact that these tax-exempt securities are largely purchased by high income investors. However, the goal is to estimate the taxes that these investors otherwise would have paid. Given the availability of alternative tax sheltered investments and the presence of financial institutions in the market, it seems that 30 percent may well be overstating the potential revenue collection.

Most importantly, the proper method of estimating revenue losses associated with tax-exempt financing is a matter of substantial disagreement among analysts. University of Chicago professors Roger Kormendi and Thomas Nagle, for example, argue that the traditional Treasury/Joint Committee approach is based upon an unrealistic view of investor behavior. Kormendi and Nagle offer their own estimates, based upon actual holding patterns revealed in Federal Reserve Board data, which yield revenue loss estimates significantly below those which result from the Treasury/Joint Committee method.

By the Kormendi/Nagle method, assuming GAO's estimate of a 15 percent taxable bond rate and a 13 percent set-aside of bond proceeds, the total revenue loss from 1982's average mortgage would amount to $5,699. Correcting GAO's assumptions further to incorporate only a 7 percent set-aside (93 percent of funds loaned) and to take account of the Joint Committee offset for reduced homeowner interest deductions, the revenue loss per average mortgage is reduced further to $3,231.

*Calculations for this and all subsequent estimates using alternative methodologies or assumptions are shown in the Appendix.

The following table summarizes the more accurate alternatives to the GAO revenue loss estimates:

REVENUE LOSS ESTIMATES
(1982 base)

Methodology	Cost per Mortgage of $43,300	Revenue Loss per $1 Billion of Mortgage Bonds
GAO	$13,300	$45 million
GAO, with offset (7% set-aside)	$10,155	$36.8 million
Kormendi/Nagle (7% set-aside; no offset)	$5,699	$19.35 million
Kormendi/Nagle (7% set-aside; with offset)	$3,231	$11.7 million

Thus, the GAO overstates revenue losses per mortgage by anywhere from 30 percent to 400 percent.

GAO further exaggerates the cost of tax-exempt financing by including the gratuitous assertion that the "actual cost per targeted household" could be four times the cost estimated in the report. This statement is based on GAO's assumption that since three out of four purchasers under revenue bond programs in 1982 had incomes above $20,000, they could have purchased homes without assistance. As is explored in detail later on, this assertion defies both common sense and actual experience in 1982 and is simply unworthy of serious consideration.

2. Benefits to Home Purchasers

As GAO overstates the costs of revenue bond financing, so does it understate the benefit to home purchasers. GAO's estimate of benefits is based upon the assumption that tax-exempt financing provided homebuyers "with an average interest rate reduction of about two percentage points" in 1982. Based on the assumed 13.75 percent tax-exempt mortgage rate, we believe that GAO would compute the average benefit to a home purchaser as $4,904.

The GAO assumptions are directly contrary to experience and consequently understate the benefit to homebuyers. While GAO assumes a tax-exempt mortgage rate of 13.75 percent, state housing finance agencies actually provided mortgage funds at an average rate of 12.32 percent in 1982. Using this figure and taking into account discount points, we can estimate that the average tax-exempt mortgage cost a homebuyer 12.5% in 1982.

This tax-exempt mortgage rate should be contrasted with a market mortgage rate of approximately 16 percent. The 16 percent figure can be reached in a variety of ways.

These include:

- The substantial majority of FHA mortgages were made at rates ranging from 15 percent to 16.5 percent. Assuming 4 to 6 points on the mortgage, an average interest cost of 16 percent seems appropriate.
- GAO's own estimate of a mortgage rate under taxable bonds is 16.18 percent.
- While rates fluctuated widely, fixed-rate, 30-year conventional mortgages tended to cost between 15 and 17 percent for most of the year. The 16 percent estimate seems conservative for the first three quarters of 1982.

Based on a spread of 3.5 percent between taxable and tax-exempt rates, the benefit to the homebuyer receiving GAO's average mortgage in 1982 would be computed as $8,533.

Rates reported by the Federal Home Loan Bank Board support the use of a 3.5 percentage point spread between mortgage bond and market rates. For 1982, the FHLBB shows an average effective interest rate of 16.7 percent for 90 percent, conventional mortgages (16.6 percent for 80 percent loans). A 3.5 percentage point spread would put tax-exempt rates at 13.2 percent.

The following table illustrates the costs and benefits of tax-exempt financing to purchasers using the rectified numbers discussed above:

COSTS AND BENEFITS OF TAX-EXEMPT FINANCING
(1982 base)

Method	Cost/Unit	Savings to Purchaser
GAO	$13,300	$8,533
GAO, with offset (7% set-aside)	$10,155	$8,533
Kormendi/Nagle	$5,699	$8,533
Kormendi/Nagle (7% set-aside, with offset)	$3,231	$8,533

3. Cost of Alternative Programs

GAO supplements its analysis of the costs and benefits of revenue bond programs with an exploration of possible alternative means of providing comparable benefits. Here, too, the GAO analysis suffers from a series of incorrect assumptions and inappropriate methodologies. Before considering these alternative approaches, therefore, it is necessary to review GAO's assumptions and make such corrections as are needed.

- As noted above, GAO assumes a rate on mortgages financed with tax-exempt bonds as 13.75 percent. This rate should be projected at 12.5 percent.

- GAO assumes that taxable mortgage funds for use in a Mortgage Grant or Tax Credit program could have been obtained at a rate of 15.18 percent (although the report also assumes that MRB loans at 13.75 percent provided an average two percentage point subsidy from market rates). Implicit in this assumption is the expectation that such funds would be raised through federally insured mortgages and federally guaranteed securities. Yet, as noted above, effective interest rates on these mortgages were closer to 16 percent in 1982.

- GAO assumes that the interest rate on tax-exempt mortgage revenue bonds averaged 12.5 percent in 1982. But the weighted average of state housing finance agency single-family bond issues in 1982 was about 12 percent. (The spread between bond and mortgage rates was reduced by large state contributions).

- The GAO estimates include no projection of administrative costs for the alternative programs. This omission further prejudices the analysis against tax-exempt bond programs, since these programs pay their own administrative expenses. In the following estimates, therefore, a modest projection of the administrative costs of non-bond financed programs is included.

- Unchanged from GAO's assumptions are (a) an average mortgage amount of $43,300; (b) 30-year, fixed-rate loans; (c) the 12-year prepayment assumption; and (d) a 13 percent discount rate for present value computations.

a. Taxable bond option

GAO's first alternative proposes that taxable bonds be issued by the same agencies which would otherwise issue tax-exempt bonds. The federal government would then pay an interest reduction subsidy to the issuer "so that its borrowing costs (are) equivalent to those incurred with tax-exempt securities."* GAO estimates the cost of such a program at $10,400 per unit. This cost is derived, according to GAO, by multiplying the bond principal amount by the difference between taxable and tax-exempt interest rates for each of the 12 years in which mortgages are outstanding.**

Using the corrected assumptions set forth above, we have computed the cost of the taxable bond option at $8,835 per unit. Note that this estimate assumes that 87 percent of the bond proceeds will be loaned for mortgages. If the 93 percent assumption is used, the proper subsidy cost would be $8,267 per unit.

b. Mortgage grant option

Under GAO's second option, the federal government would pay an up-front cash discount to mortgage lenders to provide the desired reduction in homebuyers' mortgage interest rates. GAO projects the cost of this cash grant at $3,400 per average unit, based upon the amount needed to reduce the payments on a 15.18 percent loan to the level required at a 13.75 percent interest rate. If these assumptions are corrected as explained above, the cost of the mortgage grant program rises to $8,533 per unit, representing the capitalized value of reducing payments on a 16 percent mortgage to those on a 12.5 percent loan.

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*Such a program is authorized by Section 802(c)(2) of the Housing and Community Development Act of 1974.

**We have not been able to duplicate the GAO calculation for this option, and believe there may have been an error in computation.

An estimate of administrative costs must be added to projections for the mortgage grant and tax credit programs. While any such estimate must necessarily be highly conjectural, we have attempted to provide one based upon HUD's staff costs in administering the Section 235 program. HUD estimates that 100,000 units of Section 235 housing require a total of 458 staff years of personnel time in the first year that a unit receives subsidy. It further estimates that those 100,000 units require 17 staff years annually in subsequent years. Considering only the first year costs, and assuming (as HUD does) a cost of $32,000 per staff year, first year administrative costs amount to $147 per Section 235 unit. If the Mortgage Grant option has the same administrtive costs as the Section 235 program, the total cost should be increased by $147 per unit to $8,680.

c. Tax credit option

GAO's last approach would use an annual tax credit to reduce the effective interest rate on the loan. Essentially similar to HUD's Section 235 program, this option would substitute a tax credit to the homebuyer for the "interest reduction payment" that would go to the lender under Section 235. GAO estimates the cost of this approach at $3,500 per unit, using the assumption of a taxable mortgage rate of 15.18 percent and a tax-exempt rate of 13.75 percent. As with the previous estimate, if we correct these assumptions on interest rates to 16 percent and 12.5 percent, the program cost amounts to $8,965. Adding an administrative cost of $147 per unit to the foregoing produces a total program cost for the Tax Credit option of at least $9,112.

The following table summarizes the comparative costs of tax-exempt bond financing and the various options posed by GAO:

ALTERNATIVE COST ESTIMATES
(1982 BASE)

Progam	Cost per mortgage: GAO assumptions	Cost per mortgage: alternative assumptions
Mortgage revenue bonds	$13,300	$5,699
Taxable bonds	$10,400	$8,835
Mortgage grants	$ 3,400	$8,680
Tax credits	$ 3,500	$9,112

4. Effect of Changed Assumptions

As this report has demonstrated, estimates of the cost of alternative homeownership subsidy programs will vary greatly with the interest rate assumptions used. Estimates of the cost of mortgage revenue bond subsidies will depend greatly on the overall level of interest rates, while the three alternatives will depend more on the differential between subsidized and unsubsidized rates. Consequently, limiting the analysis to one high interest rate year will necessarily bias the results against tax-exempt financing programs.

In calculating the cost of mortgage bond programs, GAO has assumed a taxable bond rate of 15 percent. But in a lower interest environment—say 13 percent—the estimated cost per subsidy for MRBs drops almost $2,000, to $11,486. At 10 percent, GAO's estimate falls to $8,835.

The cost of the proposed alternatives to tax-exempt financing depends on the spread between subsidized and unsubsidized mortgages. Taking GAO's least cost alternative as an example, we have shown that the mortgage grant program carries a per mortgage subsidy cost of $8,533 (not including administrative costs) when market rates are 16 percent and MRB loan rates are 12.5 percent. Narrowing that spread to 13.25 and 16 percent, the per unit subsidy falls to $6,733. With a larger spread—say 12.5 and 16.7—the subsidy increases to $10,272.

From this comparison of estimates across interest rate assumptions, it becomes clear that this kind of analysis will have dramatically different outcomes in different years. To illustrate, the table below compares cost estimates using GAO interest rate assumptions along with assumptions recently used by the Joint Committee on Taxation in projecting a cost for MRBs in 1984:

REVENUE LOSS ESTIMATES: 1982 vs. 1984

	Cost per mortgage: MRBs	Cost per mortgage: Mortgage Grants
GAO method - 1982 1/	$13,300	$3,500
Joint Committee method - 1982 1/	$11,013	n/a
GAO method - 1984 2/	$ 9,279	$8,042
Joint Committee method - 1984 2/	$ 6,686	n.a

1/ GAO interest rate assumptions, includes no offset.

2/ Based on interest rate assumptions used by Joint Committee on Taxation in recent revenue loss estimates for FY 84 - 88: for 1984, 10.5 percent taxable bond rate, 12 percent conventional mortgage rates and MRB mortgage rate of 70 percent of taxable bond rate plus 1.125 percent (8.475).

In short, had GAO undertaken its study in 1984, the results of its cost analysis would have looked considerably different.

5. Credit Market Effects

In addition to the dollar cost of a mortgage bond subsidy, GAO also claims that these financing programs impose a cost on the municipal bond market by driving up interest rates. They base this charge on the view that an increase in the volume of tax exempts will have a significant effect on interest rates relative to the taxable bond market.

Much of the concern about the credit market effects of MRBs stems from the rapid increase in the volume of these bonds experienced in the late 1970s. The proliferation of housing bonds gave rise to the fear that these issues would grow to overwhelm the market. But in fact, MRBs make up only a small portion of the total tax-exempt market. In 1982, MRBs totaled approximately $8 billion, which represents only about 10.5 percent of total long-term tax-exempt debt issued in that year—not 14 percent, as reported by GAO. The total was less than 2% of the total municipal bonds outstanding.

Furthermore, the Mortgage Subsidy Bond Tax Act of 1980 capped annual MRB activity on a state-by-state basis. As a result, total yearly volume cannot exceed approximately $14 billion nationwide. Whatever the effect that volume has on tax-exempt interest rates, it must be remembered that housing bonds make up only a limited portion of that market.

As evidence of credit market effects, GAO cites a 1979 study by George Peterson and Brian Cooper of the Urban Institute, Tax Exempt Financing of Housing. The Peterson estimate rests on the assumption that increases in tax-exempt volume must be purchased by taxpayers in successively lower marginal tax brackets. Since the exemption is of less value to these taxpayers, tax-exempt rates must rise to attract the new bondholders, or so the argument goes.

University of Chicago professors Roger Kormendi and Thomas Nagle again provide an alternative view, based on a much broader perspective of capital markets. They reason that, because the bulk of new tax-exempt issues are purchased by high braacket investors, the increase in interest rates required to attract purchasers is much lower than that estimated by Mr. Peterson.

The evidence supports the claim that volume is not the controlling factor in determining tax-exempt interest rates relative to the taxable market. The table below shows how, from 1972 to 1982, the spread between tax-exempt and taxable interest rtes moved up and down relatively independent of changes in volume:

RATIO OF TAX-EXEMPT TO TAXABLE INTEREST RATES[1]
(1972 - 1982)

	Long-Term Municipal Volume[2]	AAA Municipal Bonds	AAA Corporate Bonds	Ratio Municipals to Corporates
1972	$23.7 b.	5.27%	7.21%	.731
1973	$23.8 b.	5.18%	7.44%	.696
1974	$23.6 b.	6.09%	8.57%	.711
1975	$30.7 b.	6.89%	8.83%	.780
1976	$35.4 b.	6.49%	8.43%	.770
1977	$46.7 b.	5.56%	8.02%	.693
1978	$48.2 b.	5.90%	8.73%	.676
1979	$43.3 b.	6.39%	9.63%	.663
1980	$48.4 b.	8.51%	11.94%	.713
1981	$47.7 b.	10.43%	14.17%	.736
1982	$77.3 b.	10.88%	13.79%	.789

[1] Source: Board of Governors Federal Reserve System

[2] Source: Public Securities Association

Volume is only one of many factors that affects interest rates. Equally as important are changes in the demand for tax-exempt securities, such as (1) the reduction in federal income tax rates in the 1981 tax act, which narrows the market for tax-exempts; (2) the withdrawal of financial institutions from the market because of profitability problems; and (3) competition from other demanders of credit—most notably the federal government.

These factors, which affect the demand for tax-exempt securities, appear to have had a greater impact on interest rates in recent years than has the volume of new issues. Thus, the implication that restricting the use of tax-exempt financing for housing—which is already limited in volume—will dramatically affect interest rates is an unfounded conclusion.

6. Policy Considerations

The General Accounting Office analysis focuses on the monetary costs and benefits of tax-exempt financing. In doing so it neglects to consider a range of benefits and advantages of this type of financing which cannot easily be quantified. Similarly it ignores, indeed refuses even to consider, the range of practical and policy objections that might be lodged against the various options that it poses.

A primary advantage of revenue bond financing is that it operates through independent, largely self-supporting state and local agencies which can develop and implement programs tailored to the particular needs of their areas. For example, the New Jersey Mortgage Finance Agency targets its homeownership program as a revitalization tool for the state's urban centers, while the Wyoming Community Development Authority uses its program to serve areas affected by energy-related development. In many states, outreach by the state agencies is the primary source of mortgage capital for areas underserved by private financial institutions, particularly rural areas.

Similarly, housing finance agency programs can be targeted to local development objectives and to specific groups with difficulty in meeting their housing needs. As the federal presence in the delivery and support of housing diminishes, it is all the more important for independent, self-supporting state and local agencies to be able to fill the gap.

The GAO report also excludes from consideration home improvement and rehabilitation loan programs run by tax-exempt bond issuing agencies. While these activities do not directly affect the cost/benefit analysis with regard to home purchase assistance, they re-emphasize the flexibility and responsiveness of housing finance agencies.

What is most ironic about the GAO analysis is that it willfully ignores the role which the Congress expressly intended for tax-exempt home purchase finance programs in 1982 — to serve as countercyclical support for a devastated housing industry. By raising home purchase price limits and easing the first-time homebuyer requirement in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Congress relied explicitly upon the capacity of the housing finance agencies to bridge an unprecedented "affordability gap" with tax-exempt financing. Further, housing bond programs provided fixed-rate, level-payment mortgage financing at a time when such mortgages were extremely hard to find.

While state and local agencies successfully served the Congressionally-established objective of providing support to the housing industry in 1982, at the same time they maintained their focus on the moderate income, first-time homebuyer. GAO's own data on the beneficiaries of revenue bond programs in 1982 illustrates this point, as shown in Part II of this response.

PART II

BENEFICIARIES OF REVENUE BOND PROGRAMS

As with its work on cost effectiveness, GAO's analysis of the beneficiaries of revenue bond programs is both flawed and misleading. However, unlike the previous case, in which incorrect assumptions produced faulty data, GAO's conclusions with regard to homebuyers under tax-exempt programs are simply unsupported by the data which it presents or chooses not to present. Thus, GAO finds that "most subsidized home loans were not made to low and moderate income households in need of assistance, but rather to those who probably could have purchased homes without assistance." In fact, as the following analysis will demonstrate, state housing finance agencies did a remarkable job of targeting assistance to low and moderate income homebuyers who would have been priced out of the 1982 market without such help.

1. Use of 1982 Data Misleads

GAO draws its beneficiary data exclusively from 1982, a year in which tax-exempt interest rates averaged over 12 percent—a level which had not been reached even in the conventional or FHA market, prior to 1980. As a result of these high interest rates, state agencies had to reach beyond the predominantly lower income homebuyers they had served in the past. At the same time, the even higher rates in the conventional market greatly expanded the pool of borrowers in need of assistance.

In the face of these conditions, state agencies were forced to choose between serving higher income borrowers or shutting down operations. As public agencies, they chose to maintain the flow of affordable mortgage capital to homebuyers. They were encouraged to do so by both the Administration, which provided regulatory relief, and by the Congress in its TEFRA amendments to the Mortgage Subsidy Bond Tax Act of 1980.

The following table puts the 1982 experience into historical perspective. It compares the median income of borrowers under state agency programs with the national median. Note that in years prior to 1982, median borrower incomes did not exceed 85 percent of the national median. In 1982, however, borrower median incomes had to increase by nearly 30 percent and rise to 96 percent of the national median income simply in order to keep up with the unprecedented interest rates that prevailed. As interest rates return to more normal levels, state agencies will be able to shed their countercyclical role and focus once again on the lower income households which are their primary concern.

MRB HOMEBUYER INCOMES: HISTORICAL PERSPECTIVE

	Borrower Median Income(1)	National Median Income(2)	Borrower Median as % Of National Median Income
1978	$14,725	$17,640	83%
1979	$15,411	$19,587	79%
1980	$17,794	$21,023	85%
1981	$18,068	$11,388	81%
1982	$23,243	$24,200	96%

1/ Source: Council of State Housing Agencies membership survey; 24 states reporting.

2/ Source: Department of Housing and Urban Development (derived from Bureau of Census data).

2. Even in 1982, Revenue Bond Programs Served the Lowest Segment of the Home Purchase Market.

GAO states that the incomes of homebuyers under revenue bond programs "were similar to those of buyers" under the FHA unsubsidized mortgage insurance programs. The actual data for 1982, however, presents quite a different picture.

According to HUD, the median family income of the FHA unsubsidized homebuyer in 1982 was $35,556 in new homes and $32,938 in existing homes, for a weighted average of $33,166. The median income of borrowers in state housing agency programs during the same year, based on a sample of 24 states, was $23,243. In other words, the median FHA homebuyer had an income some $10,000 or 43 percent higher than the median revenue bond homebuyer. GAO does not present its findings in this form.

What is true for the median incomes of bond program and FHA buyers, is equally true across the board. The following table, illustrates the distribution of mortgage revenue bond (MRB) program and FHA homebuyers by category.

COMPARISON OF MRB AND HFA HOMEBUYER INCOMES
(1982)

	MRB	FHA
less than $15,000	10%	2%
$15,000 - 25,000	40%	21%
$25,000 - 35,000 ($35,999 for FHA)	35%	36%
$35,000 - 40,000 (36,000 - 39,999 for FHA)	14%	11%
$40,000 - 44,999		11%
$45,000 - 54,999		19%
$55,000 - 75,000	1%	
over $75,000	0	
Number of Loans	20,471	27,158

Source: MRB homebuyer incomes from Table 5 of GAO report; FHA homebuyer incomes from annual report of FHA insurance programs for 1982.

The foregoing table illustrates that fully 50 percent of revenue bond program homebuyers — in 1982 — had incomes of $25,000 or less; only 23 percent of FHA buyers had incomes below this level. Further, only 15 percent of revenue bond program buyers had incomes over $35,000, compared to 41 percent of FHA buyers. Given the dramatic drop in interest rates during the last quarter of 1982, which enabled lower income buyers to enter the FHA program, the inclusion of loans made during this period in the FHA distribution tends to understate the difference in borrower incomes.*

Beyond the FHA/revenue bond home purchaser comparison, GAO simply misrepresents the data with regard to incomes of bond program participants. Thus, GAO states that "the typical mortgage revenue bond homebuyer in 1982" had an income "between $20,000 and $40,000." In fact, the "typical" revenue bond homebuyer had an income below $25,000 and, as GAO's own data indicates, 72 percent of these buyers had incomes below $30,000.

A similar distortion is contained in GAO's statement that "53 percent of the subsidized borrowers were among the more affluent half of the families in their States." What this statement means, of course, is that in a period of unprecedented high interest rates, nearly half the revenue bond program homebuyers had incomes below the area median income and, as GAO points out later, 64 percent of buyers had incomes below 115 percent of median. Finally, GAO's data indicates that 23 percent of homebuyers receiving bond financed loans had incomes at or below 80 percent of the state median income, the level of eligibility for Section 8 "deep subsidy" housing assistance.

In any year, the performance of state agencies as described by GAO would be most commendable for their success in reaching the lower segment of the homebuying public. Under the conditions which prevailed in 1982, this achievement is nothing short of remarkable.

3. Revenue Bond Program Beneficiaries Could Not Have Purchased Homes Without This Assistance.

GAO asserts that "three quarters of (bond program) buyers had incomes above $20,000 and could likely have purchased homes anyway," i.e. without revenue bond assistance. No data is offered in support of this novel proposition, and any reasonable analysis leads to quite a different conclusion.

According to the National Association of Home Builders, the median sales price of existing homes in 1982 was $67,800 ($69,300 for new homes). At interest rates of 15.5 percent or higher, which prevailed for most of 1982, an income of more than $38,000 would be required to purchase such a house.* Fewer than 10 percent of revenue bond homebuyers had incomes at this level.

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*Two additional, perhaps offsetting, factors may be considered with regard to the FHA/MRB comparison. First, a substantial number of FHA insured loans may have been made through revenue bond programs, most likely those loans at the lower end of the FHA distribution. GAO dismisses this fact with a brief statement but no data. On the other hand, GAO asserts that the presence of previous homeowners in the FHA sample, compared to the revenue bond program's first time homebuyers, may drive up incomes for the FHA buyers. It is equally plausible, however, that because previous homeowners have accumulated equity for larger down payments, they can purchase a particular house at a lower income level than a comparable first time homebuyer who can not make an equivalent down payment.

Of course, affordability problems would be eased for families willing to buy homes priced below the median. However, 1982's high interest rates made even modestly priced homes unaffordable to the kind of buyer served by the revenue bond programs. Thus, a home priced at $50,850—75 percent of the median sales price for existing homes in 1982—would require a homebuyer income of over $28,999 at an interest rate of 15.5 percent** Far fewer than 50 percent of revenue bond program homebuyers had incomes at this level.

"How much home" could the average revenue bond program homebuyer have afforded in 1982 without a bond financed mortgage? At a 15.5 percent interest rate, a household with an income of $23,243 could afford a home costing $41,200. According to the National Association of Realtors data for June 1982, only 15 percent of existing homes sold nationwide cost $40,000 or less. In the West, only 3.4 percent of homes sold in this range and in the South, the most active home building section of the country, only 13.3 percent of homes would have been affordable to the typical revenue bond homebuyer if he or she had been unable to obtain tax-exempt financing. The following table explores the relationship among affordability, revenue bond program beneficiaries, incomes and home sale prices in greater detail.

HOUSING AFFORDABILITY AND AVAILABILITY
(1982)

Income	"Affordable" Home at 15.5% FHA Rate(1)	% of Homes w/in Price Range(2)	"Affordable" Home at 12.0% MRB Rate(1)	% of Homes w/in Price Range(2)
$15,000	$26,600	Below 6%	$33,700	Below 11%
$20,000	$35,500	Below 12%	$45,000	21%
$23,246 (MRB MEDIAN)	$41,200	16%	$52,300	30%
$25,000	$44,300	21%	$56,200	33%
$30,000	$53,200	31%	$67,500	48%
			(MEDIAN EXISTING HOME)	
$38,000	$67,400	48%		
	(MEDIAN EXISTING HOME)			

1/ Assumes 30 year, level payment mortgage; 25% ratio between principal and interest payment and gross income.

2/ NAR data for June 1982, interpolated within $10,000 price intervals.

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*Assumes 90% mortgage, 30-year term, 25% of income allocated to principal and interest payments. While some lenders used higher payment to income ratios in 1982, these normally included taxes and insurance in the payment and a "net" rather than a "gross" measure of income.

**Same assumptions in the previous example.

In summary, analysis of the available data supports the conclusion dictated by both common sense and experience: the moderate income homebuyers served by revenue bond programs would otherwise have been priced entirely out of 1982's housing market by high interest rates and sales prices.

4. Further Income Restraints and Purchase Price Limits Are Unnecessary.

GAO asserts that Federal home purchase price ceilings and state or locally set income limits "have been ineffective" in targeting revenue bond mortgages to low and moderate income households. Thus, GAO states that "income ceilings allowed" and "purchase price ceilings encouraged" use of the program "by middle- and upper-income households." Here, again, GAO ignores both the substantial affordability problems faced by issuers under 1982's interest rates and the remarkable degree of targeting to below median households that was actually achieved.

With regard to income limits, GAO acknowledges that all but two state agencies and two local jurisdictions established income ceilings for home purchasers. GAO was evidently concerned, however, that the majority of the ceilings were "in the $30,000 to $40,000 range" and only "a few set income requirements below $20,000 for a portion of the bond funds."

Under the interest rate and purchase price conditions which prevailed in 1982, state and local issuers had to make their programs available to a somewhat higher income group if they were going to continue to operate. Particularly in the view of the need for a broad range of potential homebuyers and eligible homes within the scope of any bond issue, an arbitrary income limit would simply have prevented issuers fromplaying the countercyclical role which Congress and the Administration allotted to them in 1982.

In 1980, Congress specifically rejected rigid national income limits for the revenue bond program precisely because such limits were meaningless, even destructive, if established without regard to interest rates and to local market conditions. Thus, in 1979, with conventional interest rates around 10 percent and tax-exempt rates between 7 and 8 percent, Congress contemplated an income cap of 115 percent of median. Under those conditions, such a cap would have permitted the great majority of state programs to continue to operate. However, in 1982, with interest rates more than 50 percent higher than those in 1979, a 115 percent of median income limit would have shut down many, if not most, programs. Although, as GAO points out, only one-third of homes purchased under the revenue bond programs actually went to households above 115 percent of median, the ability to market to this group undoubtedly played a major role in enabling issuers to sell bonds and achieve satisfactory interest rate levels.

Had an income limit been set at the 80 percent of median level, which GAO appears to believe to be desirable and which has been the income limit in the deep subsidy Section 8 program, it is virtually certain that no bond programs could have functioned in 1982, at least without substantial additional federal or state subsidy.

Further, GAO's analysis of income limits ignores the actual targeting to lower income households that was achieved in 1982. As was explored above in detail, the median revenue bond program homebuyer had an income below the national median and approximately $10,000 below that of the median FHA homebuyer — the lowest income unsubsidized buyer in the housing market. It is plainly unreasonable to suggest that a higher degree of targeting could have or should have been achieved under 1982's conditions.

GAO further contends that the purchase price ceilings did not limit, indeed actually "encouraged", participation by "upper income people." As evidence it offers analysis showing that "buyers would have needed annual incomes of at least $30,000 and $25,000 respectively to purchase new and existing homes" at the average ceilings which existing in 1982. This analysis, of course, re-emphasizes the significance of 1982's interest rates. Homes selling at the average price in an area were simply beyond the reach of the median income homebuyer, even at tax-exempt interest rates. Nonetheless, in order to permit issuers to serve a countercyclical role, Congress increased purchase price ceilings in mid-1982.

As with income limits, the discussion of purchase price ceilings ignores the actual results obtained in 1982. GAO found the average purchase price of mortgage revenue bond financed houses in its sample to be $48,800, hardly luxury priced housing. National Association of Realtors data shows that only 25 percent of the existing homes sold in the United States in June 1982 would have fallen within this price range. Only 10 percent of the homes financed by state agencies in 1982 had a sales price over $60,000 — a price still well below the national average.

Revenue bond programs financed modestly priced housing in 1982, they have over the past several years. The following table illustrates that fact:

MRB HOME SALES PRICES: HISTORICAL PERSPECTIVE

	MRB Median Sales Price(1)	National Median Sales Price(2)	MRB Median as % of National
1978	$45,866	$55,700	64%
1979	$37,515	$62,900	59%
1980	$42,438	$64,600	66%
1981	$43,233	$68,900	63%
1982	$43,791	$69,300	63%

1/ Source: Council of State Housing Agencies membership survey; 24 states reporting.
2/ Source: Department of Housing and Urban Development (derived from Bureau of the Census data).

Thus, there is no evidence to support the claim that purchase price limits "encouraged" the participation of higher income households in revenue bond programs. Rather, it simply took more income in 1982 for homebuyers to be able to afford modestly priced housing.

5. Federal Policies and State Agency Practices Effectively Target Revenue Bond Benefits.

As GAO acknowledges, Congress intended the revenue bond program to serve those households that could not afford to purchase homes without assistance. GAO's misrepresentation of its data cannot disguise the fact that—despite record high interest rates and the worst housing depression since World War II—state and local bond programs served precisely this function in 1982. As economic conditions continue to improve, their ability to aid the lowest end of the spectrum of first-time homebuyers will grow and their record of achievement should improve even further.

APPENDIX

TAX-EXEMPT MORTGAGE REVENUE BONDS: COST

1. Alternative assumption: offset for lower mortgage interest tax deduction

cost = bond principal x taxable bond interest rate x marginal tax bracket of investors

= \$1 bil x .15 x .30

= \$45 mil

offset = bond principal x % lendable x difference between MRB & market mortgage rates x tax bracket of homebuyer

= \$1 bil x .87 x (.16 - .125) x .25

= \$7,612,500

$$\frac{\text{net cost per \$1 bil}}{\text{number of loans originated}} = \frac{\$37,387,500}{20,092} = \text{\$1,861 per mortgage per year}$$

SUBSIDY COST PER MORTGAGE = \$11,013

2. Alternative assumption: 93 percent of bond proceeds originated as mortgages

$$\frac{\text{cost per \$1 bil}}{\text{number of loans originated}} = \frac{\$45\text{ mil}}{21,478} = \text{\$2,095 per mortgage per year}$$

SUBSIDY COST PER MORTGAGE = \$12,397

3. Alternative assumptions: 93 percent lendable proceeds and offset for lower mortgage interest deductions

offset = bond principal x % lendable (93%) x difference between MRB and market rates x tax bracket of homebuyer

offset = \$8,137,500

$$\frac{\text{net cost per \$1 bil}}{\text{number of loans originated}} = \frac{\$36,862,500}{21,478} = \text{\$1,716 per mortgage per year}$$

SUBSIDY COST PER MORTGAGE = \$10,155

4. Alternative assumption: subsidy cost per mortgage based on Kormendi/Nagle revenue loss estimate

$$\frac{\text{cost per \$1 bil}}{\text{number of loans originated}} = \frac{\$19.35\text{ mil}^{(1)}}{20{,}092} = \$963\text{ per mortgage per year}$$

SUBSIDY COST PER MORTGAGE = $5,699

5. Alternative assumptions: Kormendi/Nagle revenue loss estimate, 93 percent lendable proceeds, and offset for lower tax deduction

Kormendi/Nagle estimated cost per $1 billion = $19.35 mil
Offset per $1 billion = $7,612,500

$$\frac{\text{net cost per \$1 billion}}{\text{number of loans originated}} = \frac{\$11{,}737{,}500}{21{,}478} = \$546\text{ per mortgage per year}$$

SUBSIDY COST PER MORTGAGE = $3,231

1/ Based on 10 percent taxable bond rates, the Kormendi/Nagle analysis yields an estimate of $13 million per billion (43 percent of the standard estimate); at 14 percent, Kormendi/Nagle estimate a loss of $18 million (again, 43 percent of the standard estimate). For the purpose of analysis at 15 percent, we have assumed the Kormendi/Nagle estimate at 43 percent of $45 million—or $19.35 million.

TAX EXEMPT MORTGAGE REVENUE BONDS: BENEFITS

1. Alternative assumptions: 16 percent market mortgage rate and 12.5 percent tax-exempt mortgage rate

Monthly payment on 30-year, $43,300 mortgage at 16 percent = $582

Monthly payment on 30-year, $43,300 mortgage at 12.5 percent = $462

Annual savings on reduced rate mortgage = $1,442

AVERAGE SUBSIDY VALUE = $8,533

TAXABLE BOND OPTION

1. Alternative assumptions: 15 percent taxable bond rate and 12 percent tax-exempt bond rate

$$\text{cost} = \text{bond principal} \times \text{taxable bond rate} - \text{tax-exempt bond rate}$$

$$= \$1 \text{ bil} \times (.15 - .12)$$

$$= \$30 \text{ mil}$$

$$\frac{\text{cost per \$1 bil}}{\text{number of loans originated}} = \frac{\$30 \text{ mil}}{20{,}092} = \$1{,}493 \text{ per mortgage per year}$$

SUBSIDY COST PER MORTGAGE = $8,835

2. Alternative assumptions: 15 percent taxable bond rate, 12 percent tax-exempt bond rate, and 93 percent lendable proceeds.

$$\frac{\text{cost per \$1 bil}}{\text{number of loans originated}} = \frac{\$30 \text{ mil}}{21{,}478} = \$1{,}397$$

SUBSIDY COST PER MORTGAGE = $8,267

MORTGAGE GRANTS

1. Alternative assumptions: 16 percent market mortgage rate and 12.5 percent tax-exempt mortgage rate.

Monthly payment on 30-year, $43,300 mortgage at 16 percent = $582

Monthly payment of 30-year, $43,300 mortgage at 12.5 percent = $462

Annual savings on reduced rate mortgage = $1,442

SUBSIDY COST PER MORTGAGE = $8,533
(Does not include administrative costs)

TAX CREDITS

1. Alternative assumptions: 16 percent market mortgage rate and 12.5 percent tax-exempt mortgage rate

cost = mortgage amount x market mortgage rate - tax-exempt mortgage rate

= $43,400 x (.16 - .125)

= $1,515 per mortgage per year

SUBSIDY COST PER MORTGAGE = $8,965
(Does not include administrative costs)

Mr. DOWNEY. Thank you for your excellent statement, Mr. Richie. As you can see, the red light is blinking so any moment you may self-destruct.

I do want to welcome Mr. Ford. Wallace, it is a pleasure to see you here. Your recent appointment by our fine Governor shows he has the greatest respect for you, having served in all three branches of government. We are delighted to have you here as well.

Mr. CONABLE. I would like to welcome Mr. Ford, too. He has been a strong public servant in New York and we are proud of you.

STATEMENT OF WALLACE L. FORD II, EXECUTIVE DIRECTOR AND CHIEF EXECUTIVE OFFICER, STATE OF NEW YORK MORTGAGE AGENCY

Mr. FORD. I am Wallace Ford, executive director and chief executive officer of the State of New York Mortgage Agency, also known by the acronym, SONYMA. I am speaking today to respectfully urge your support for the Housing Finance Opportunity Act of 1983. I am here today both representing that agency and also Governor Mario Cuomo who intended to be here to testify in support of the Housing Finance Opportunity Act, but due to the commitments involving the State Legislature as it ends the session in Albany, he was unable to be here and I was asked to indicate his regrets at not being able to attend this morning.

Since its establishment in 1970 as a public tax-free organization, SONYMA has played a vital role in revitalizing New York State's older neighborhoods and in increasing the supply of funds in the private banking system for new residential mortgage loans. During the past 12 years, the agency has issued over $1.2 billion in tax-exempt revenue bonds, providing financing for an estimated 30,000 new residential loans.

During the past 12 years, the agency has issued over $1.2 billion in tax-exempt mortgage revenue bonds providing financing for an estimated 30,000 new residential loans. Under the Mortgage Subsidy Bond Tax Act, the agency was the first to issue bonds and by doing so became a model for many other States. Since passage of the legislation, the agency has fulfilled a very critical need in the State of New York by providing mortgage financing for thousands of moderate income families and first-time home buyers at times when market interest rates were 4 percentage points more than SONYMA's.

Of equal importance, the agency has provided a large number of high loan-to-value ratio mortgages which enabled many moderate income households to purchase homes with low down payments. Therefore, without SONYMA's unique financing capabilities, many moderate income households would have never been able to realize the American dream of home ownership.

The national average is 13.3-percent interest rates and we are hopeful with our current bond sale that will go forward at the end of this month we will be able to provide mortgage financing at 10½ percent or lower.

Of equal importance, however, the agency has provided a large number of high loan-to-value ratio mortgages which have enabled many households to purchase loans with low down payments. Our program calls for a minimum 5-percent down payment. Without this unique financing capability, many moderate income households would never have been able to realize the dream of home ownership. Particularly for those that cannot afford the 12½ to 13 percent mortgages available on a mixed rate basis, the conventional rate is still high enough to discourage many moderate income households from buying homes.

SONYMA's program is tailored to assist moderate income families. While there are no income limits for borrowers, purchase price limits help insure that the available mortgage funding will reach as broad a population as possible. A decline in interest rates works even better for SONYMA's ability to reach a larger number of lower income households.

With respect to our expected bond sale at the end of this month, we should have a rate of 10½ or lower depending on market conditions. This difference means that a household with an income of as low as $21,600 could afford to buy a $40,000 home, whereas an income of $25,200 would be necessary to buy the same home at a 13-percent interest rate. And I would add that the national average is 13.3 percent.

The Economic Recovery Tax Act of 1981 enabled lending institutions to compete with money market funds for deposits which has allowed a greater influx of capital into banks' portfolios, however, there is evidence to suggest that they are not funneling a large amount of this capital into long-term financing. Generally, lending institutions have shown an unwillingness to enter into long-term fixed rate transactions.

In New York, it is a 30-year mortgage with 5-percent down payment which is a favorable set of terms in current conditions.

As you are aware, FHA rates went up to 12 percent last week. This is even more indicative of the continued unpredictability of the mortgage financing market and the importance of State housing agencies' continued ability to provide some stability to the mortgage market. The shortage of mortgage financing in private banking channels has created a situation where New York State is faced with a decline in home sales, a decline in housing starts, and an increase in the number of substandard housing units.

SONYMA is prepared to meet the challenge of promoting and developing older communities and neighborhoods throughout the State of New York. The agency encourages the coordination of projects by local and nonprofit agencies in conjunction with SONYMA participating banks to stimulate home ownership opportunities in all areas of the State. This includes the leveraging of secondary sources of funding such as urban development action grants and community development block grants.

The agency intends to continue to make strong attempts to provide financing for special projects such as condominiums and cooperatives for which there has been an increase in demand but lender reluctance to provide adequate financing. The agency also encourages the preservation of existing public capital structures through the conversion of vacant school buildings and other facilities where new units can be sold individually to the home buyer as condominium or cooperative units.

Government at all levels and the private sector as well have an obligation to promote policies and programs that enhance universal access to jobs and housing. Historically, the opportunities that this country has afforded its citizens have been based to a significant extent upon an adequate supply of available, affordable and decent housing.

There has always been a connection between economic development and housing development and there is a concomitant effect to the extent we see housing and housing development and to the extent we see larger numbers of the people able to purchase housing and we will see greater economic development benefits for all people throughout the community.

The benefits of home ownership to New York State communities in need of redevelopment or where there remains a high incidence of poverty is crucial to the stability and positive growth of those communities.

Mortgage revenue bonds are a creative and practical way to leverage public and private dollars to fulfill various public needs. Further, this approach is totally consistent with the pragmatic concept of public fiscal responsibility and the responsibility of government to promote and foster an environment which will improve the general living conditions of all people.

I strongly encourage your full support of this legislation and thank you for the opportunity to present these views on behalf of the State of New York Mortgage Agency and Governor Cuomo.

Thank you.

Chairman ROSTENKOWSKI [presiding]. Thank you.

[The prepared statement follows:]

STATEMENT OF WALLACE L. FORD II, EXECUTIVE DIRECTOR/CHIEF EXECUTIVE OFFICER, STATE OF NEW YORK MORTGAGE AGENCY

Mr. Chairman and distinguished members of the Committee, good morning. I am Wallace L. Ford II, Executive Director and Chief Executive Officer of the State of New York Mortgage Agency, also known by the acronym, SONYMA. I am speaking today to respectfully urge your support for the Housing Finance Opportunity Act of 1983.

Since its establishment in 1970 as a public benefit corporation, SONYMA has played a vital role in revitalizing New York State's older neighborhoods and in increasing the supply of funds in the private banking system for new residential mortgage loans. During the past 12 years, the Agency has issued over $1.2 billion in tax-exempt revenue bonds, providing financing for an estimated 30,000 new residential loans. As of March 31, 1983, over $63,000,000 of the funds had gone into new construction, allowing for the creation of approximately 1,274 jobs throughout the State of New York. Before the enactment of the Mortgage Subsidy Bond Tax Act of 1980, SONYMA provided financing for mortgages without the current 20 percent targeting requirement and first-time homebuyer restriction. During this period, the Agency issued over $645,000,000 which provided financing for approximately 17,000 homes.

Under the Mortgage Subsidy Bond Tax Act, the Agency was the first to issue bonds and by doing so became a model for many other states. Since passage of the legislation, the Agency has fulfilled a very critical need in the State of New York by providing mortgage financing for thousands of moderate income families and first-time homebuyers at times when market interest rates were four percentage points more than SONYMA's. Of equal importance, the Agency has provided a large number of high loan-to-value ratio mortgages which enabled many moderate income households to purchase homes with low downpayments. Therefore, without SONYMA's unique financing capabilities, many moderate income households would have never been able to realize the American dream of homeownership.

While the mortgage market is currently more advantageous for homebuyers than it has been in the past few years, and particularly for those households that can afford 12½ to 13¼ percent mortgages, the conventional rate is still high enough to discourage many moderate income households from buying homes who could benefit from programs like SONYMA's. SONYMA's program is tailored to assist moderate income families. While there are no income limits for borrowers, purchase price limits help insure that the available mortgage funding will reach as broad a population as possible. A decline in interest rates works even better for SONYMA's ability to reach a larger number of lower income households. For example, the rate for SONYMA's anticipated bond sale in July will probably be below 10½ percent, depending on prevailing market conditions. This difference means that a household with an income of as low as $21,600 could afford to buy a $40,000 home, whereas an income of $25,200 would be necessary to buy the same home at a 13 percent interest rate.

The Economic Recovery Tax Act of 1981 enabled lending institutions to compete with money market funds for deposits which has allowed a greater influx of capital into banks' portfolios however, there is evidence to suggest that they are not funneling a large amount of this capital into long term financing. Generally, lending institutions have shown an unwillingness to enter into long-term fixed rate transactions.

According to a finding from the New York State Superintendent of Banks, as of April 1, 1983, no predictable increase in one to four-family mortgages or commitment activity was evident on New York properties from the generally depressed levels of 1981 and 1982. A closer look at lenders' reluctance to issue new mortgage loans is revealed by the statistics on the sale of existing housing in New York State which show no significant increase in mortgage activity over the comparable period of last year.

As you may very well know, FHA rates went up to 12 percent last week. This is even more indicative of the continued unpredictability of the mortgage financing market and the importance of state housing agencies' continued ability to provide some stability to the mortgage market. The shortage of mortgage financing in private banking channels has created a situation where New York State is faced with a decline in home sales, a decline in housing starts, and an increase in the number of substandard housing units.

Over the past 20 years, housing starts in New York State have averaged 75,000 per year while in 1981 they totaled only 29,800. In New York City, where the conditions of the city's occupied rental stock in terms of both dilapidation and maintenance has deteriorated since 1978, adequate homeownership opportunities are more scarce than in other parts of the State.

Moreover, despite a population loss of 689,000 since 1970 in New York State, there has been a 427,000 increase in the number of households resulting in an increase in the number of potential first-time homebuyers.

Affordability has always been and will continue to be a real problem to the ability of low and moderate income households to buy homes. The Agency is endeavoring to expand its targeted area program in order to make the program available to a larger lower income population base. While 11 percent of all single family structures within the State currently fall within currently approved targeted areas, 34 percent of the State's single family structures would fall in targeted areas under the Agency's expanded program.

SONYMA is prepared to meet the challenge of promoting and developing older communities and neighborhoods throughout the State of New York. The Agency encourages the coordination of projects by local and non-profit agencies in conjunction with SONYMA participating banks to stimulate homeownership opportunities in all areas of the State. This includes the leveraging of secondary sources of funding such as Urban Development Action Grants and Community Development Block Grants. The Agency intends to make strong attempts to provide financing for special projects such as condominiums and cooperatives for which there has been an increase in demand but lender reluctance to provide adequate financing. The Agency also encourages the preservation of existing public capital structures through the conversion of vacant school buildings and other facilities where new units can be sold individually to the homebuyer as condominium or cooperative units.

Government at all levels and the private sector as well have an obligation to promote policies and programs that enhance universal access to jobs and housing. Historically, the opportunities that this country has afforded its citizens have been based to a significant extend upon an adequate supply of available, affordable and decent housing. The benefits of homeownership to New York State communities in need of redevelopment or where there remains a high incidence of poverty is crucial to the stability and positive growth of those communities.

Mortgage revenue bonds are a creative and practical way to leverage public and private dollars to fulfill various public needs. Further, this approach is totally consistent with the pragmatic concept of public fiscal responsiblity and the responsibility of government to promote and foster an environment which will improve the general living conditions of all people. I strongly encourage your full support of this legislation and thank you for the opportunity to present these views on behalf of the State of New York Mortgage Agency.

STATEMENT OF ROGER KORMENDI, ASSOCIATE PROFESSOR OF ECONOMICS, UNIVERSITY OF CHICAGO, GRADUATE SCHOOL OF BUSINESS

Mr. Kormendi. Thank you, Mr. Chairman, I am Roger Kormendi, associate professor of economics at the University of Chicago, Graduate School of Business. During the past 6 years, I have researched some of the key issues relating to tax-exempt financing. I have written jointly with my colleague, Prof. Michael Mussa, a book entitled "The Taxation of Municipal Bonds: An Economic Appraisal." I have written several papers jointly with my colleague, Prof. Thomas Nagle, on issues relating to the costs of tax-exempt revenue bonds. In those papers, we estimate the effect of additional tax-exempt financing on Federal tax revenues and tax-exempt interest rates.

Our research indicates that both of these effects are substantially smaller than the estimates commonly cited by critics of tax-exempt financing. We have shown the effect on tax-exempt interest rates of an additional $1 billion on mortgage revenue bonds to be about 0.6 basis points—much less than the commonly cited 4 to 7 basis points. We have estimated the effect on Federal tax revenues to be around $8 million per billion dollars of MRB's—less than half the estimates generally made by the Treasury and the Congressional Budget Office. A recent GAO report, that has received the attention of this committee, produces revenue less estimates even larger but analytically more flavored, than those of the Treasury and CBO.

The reason the CBO and Treasury figures are so inflated is that they are based on assumptions about investors' portfolio holdings that do not conform to the facts. In coming to their estimates, the CBO and the Treasury assume that investors select their portfolios of assets based entirely on considerations of the tax treatment of those assets Investors who face the highest marginal tax rates are presumed to hold exclusively tax-exempt bonds. Middle-income investors are presumed to hold exclusively partially tax assets, such as corporate equity. Finally, investors subject to low marginal tax rates are presumed to hold exclusively taxable bonds.

The CBO and the Treasury thus envision that new MRB's must be absorbed via a domino effect which causes only the highest taxed holders of equity to switch from holding equity to holding municipal bonds. The equity given up by the new tax-exempt bond holders is then, in this view, purchased only by the highest taxed holders of taxable bonds, who give up those bonds to hold the equity. This view leads to a very large estimate of the tax revenue effect of MRB's. Unfortunately, it is an estimate entirely inconsistent with the facts.

Consider the facts. Federal Reserve Board data reveal no distinct grouping of investors holding exclusively certain types of assets. In particular, household investors in all income classes hold corporate equity in like amounts. Even nonprofit institutions and pension funds, though they are subject to no taxes at all, hold substantial amounts of equity and are capable of making substitutions between equity and taxable bonds. The CBO-Treasury view of asset holdings is clearly indefensible in light of this data.

The problem with the CBO-Treasury view is that it involves only tax treatment considerations and ignores risk-return considerations in the structuring of investors portfolios. In the decision of whether to hold taxable bonds as opposed to tax-exempt bonds, the main consideration is the marginal tax bracket. However, in deciding what fraction of their portfolios to hold in equity and what fraction to hold in bonds, investors balance the risk they are willing to bear against the extra return. The higher return that accompanies its higher risk induces investors in all marginal tax brackets, even zero tax bracket institutional investors, to hold equity. Thus, for the full spectrum of investors in all tax brackets, an important opportunity for substitution is between equity and bonds. The consequences of recognizing the full spectrum of adjustment is lower losses in Federal tax revenues than the Treasury and CBO estimate.

With respect to the issue of the interest rate effect, the Treausry and CBO have assumed that the tax-exempt interest rate would increase by about five basis points. This assumption derives from a statistical estimate made by George Peterson of the Urban Institute. Unfortunately, Mr. Peterson made several economic and statistical errors in his analysis that we discuss in our papers. We, therefore, reestimated the interest rate effects, taking into account lagged portfolio adjustment, the effects of inflation and the integrated structure of capital markets, and discovered that the true effect was about 0.6 basis points—approximately one-tenth as large as the effect assumed by the Treasury and CBO.

In a recent statement, however, the Treasury lowers their basis point estimates to correspond more closely with ours and I welcome that.

Thank you.

[The prepared statement follows:]

STATEMENT OF ROGER C. KORMENDI

I am Roger Kormendi, Associate Professor of Economics at the University of Chicago, Graduate School of Business. During the past six years, I have researched some of the key issues relating to tax-exempt financing. I have written jointly with my colleague, Professor Michael Mussa, a book entitled "The Taxation of Municipal Bonds: An Economic Appraisal." I have written several papers jointly with my colleague, Professor Thomas Nagle, on issues relating to the costs of tax-exempt revenue bonds. In those papers, we estimate the effect of additional tax-exempt financing on federal tax revenues and tax-exempt interest rates.

Our research indicates that both of these effects are substantially smaller than the estimates commonly cited by critics of tax-exempt financing. We have shown the effect on tax-exempt interest rates of an additional $1 billion of Mortgage Revenue Bonds to be about .6 basis points—much less then the commonly cited 4-7 basis points. We have estimated the effect on federal tax revenues to be around $8.0 million dollars of bonds—less than half the estimates generally made by the Treasury and the Congressional Budget Office.

The reason the CBO and Treasury figures are so inflated is that they are based on assumptions about investor's portfolio holdings that do not conform to the facts. In coming to their estimates, the CBO and the Treasury assume that investors select their portfolios of assets based entirely on considerations of the tax treatment of those assets. Investors who face the highest marginal tax rates are presumed to hold exclusively tax-exempt bonds. Middle income investors are presumed to hold exclusively partially tax assets, such as corporate equity. Finally, investors subject to low marginal tax rates are pressured to hold exclusively taxable bonds.

The CBO and the Treasury thus envision that new MRB's must be absorbed via a "domino effect" which causes only the highest taxed holders of equity to switch from holding equity to holding municipal bonds. The equity given up by the new tax-exempt bond holders is then, in this view, purchased only by the highest taxed holders of taxable bonds, who give up these bonds to hold the equity. This view leads to a very large estimate of the tax revenue effect of MRB's. Unfortunately, it is an estimate entirely inconsistent with the facts on actual asset holdings in the economy and with generally accepted and empirically verified portfolio theory based on risk-return as well as tax considerations.

Consider first the facts. Federal Reserve Board data, presented in the accompanying Table, reveal no distinct grouping of investors holding exclusively certain types of assets. In particular, household investors in all income classes hold corporate equity in like amounts. Even nonprofit institutions and pension funds, though they are subject to no taxes at all, hold substantial amounts of equity. The CBO-Treasury view of asset holdings is clearly indefensible in light of this data.

The problem with the CBO-Treasury view is that it involves only tax treatment considerations and ignores risk-return considerations in the structuring of investors portfolios. In the decision of whether to hold taxable bonds as opposed to tax-exempt bonds the main consideration is the marginal tax bracket of the investor. However, in deciding what fraction of their portfolios to hold in equity and what fraction to hold in bonds investors balance the risk they are willing to bear against the extra return risk-bearing provides. The higher return that accompanies its higher risk induces investors in all marginal tax brackets, even zero tax bracket institutional investors, to hold equity. Thus, for the full spectrum of investors in all tax brackets, an important opportunity for substitution is between equity and bonds. The consequences of recognizing the full spectrum of adjustment is much lower losses in federal tax revenues than the Treasury and CBO estimate.

With respect to the issue of the interest rate effect, the Treasury and CBO have generally assumed that the tax-exempt interest rate would increase by about five basis points for each additional billion dollars of tax-exempt revenue bonds issued. This assumption derives from a statistical estimate made by George Peterson of the Urban Institute. Unfortunately, Mr. Peterson made several economic and statistical errors in his analysis that we discuss in our papers. We therefore reestimated the interest rate effects, taking into account lagged portfolio adjustment, the effects of inflation and the integrated structure of capital markets, and discovered that the true effect was about .6 basis points—approximately one-tenth as large as the effect assumed by the Treasury and CBO. As a matter of common sense, an estimate of five basis points per billion dollars of tax-exempt bonds must be far off. If the interest rate effect were five basis points, the entire difference between taxable and tax-exempt interest rates would be eliminated by only 60 billion dollars of new tax-exempt bonds. This increase would represent less than 2 percent of all assets yielding taxable income, and it certainly could not reduce to zero the value of the tax exemption to all investors.

Chairman ROSTENKOWSKI. Mr. Tetreault, you may proceed.

STATEMENT OF BERNARD L. TETREAULT, PRESIDENT, ASSOCIATION OF LOCAL HOUSING FINANCE AGENCIES

Mr. TETREAULT. Good morning. I am Bernard Tetreault, executive director of the Housing Opportunities Commission of Montgomery County, Md., and also the president of the Association of Local Housing Finance Agencies known as ALHFA. I am here to testify on ALHFA's behalf in support of H.R. 1176. I would like to briefly indicate to you who ALHFA is, and why these bonds are important to us and indicate several examples in summary form departing somewhat from the prepared statement which I have submitted for the record.

ALHFA represents housing agencies in every region of the United States. Our members include agencies in rural areas, suburban townships and large cities. Some ALHFA members have responsibility for all aspects of community development while others supervise only housing finance programs. We have a diverse membership, with one common goal: To provide high quality, affordable housing for some of those who are otherwise unable to purchase homes.

It is difficult for anyone to buy a house, but for those with low and moderate incomes, it is virtually impossible to afford the costs associated with ordinary mortgages.

The need for this legislation is evident. In 1979, an annual income of $25,523 was needed to qualify for a 10.78 percent 30-year fixed rate mortgage to purchase a house at the median price of $56,825. In 1982, when mortgage interest rates were much higher—15.15 percent—the median house price had risen 20 percent to $68,185, while the income needed to purchase the home rose 36 percent to $37,795.

Public Law 96-499, the Mortgage Subsidy Bond Tax Act of 1980, put limits on the bonds and directed their use. I think you can declare the war won. The intent of Congress with that bill has been achieved and the sunset provision can now be removed.

Local housing agencies have been responsible providers of home financing at a time of inordinately expensive homes and mortgages.

I would like to indicate the creative ways that locals deal with these situations because they have the needs of the community right at hand, they are familiar with them, they can tailor programs to their needs, and they have done so around the country.

Right here at your doorstep in Montgomery County we have taken an inclusionary zoning requirement for producing moderate-income units in otherwise expensive subdivisions and overlaid this mortgage incentive and gotten incomes served down even further.

As a broad-based housing agency, we operate public housing, we have had renters, low-income renters in our units for years and through the use of these lower interest rate mortgages we have made homeowners out of these lower income families who have proven an ability to pay their bills. Our agency includes affirmative marketing efforts in these bond's cost of issuances in order to be sure they are used by a wide variety of people in our community.

The mortgages went to households with incomes averaging $24,000, less than the Montgomery County median income of $39,000. As you know, we have one of the highest median incomes in the United States. While we have average home values of $111,000, but the average mortgage revenue bond-financed home was half that at $55,000.

That succcess is demonstrated in other areas of the country. Chicago has a small but effective local program. Pittsburgh is similar; last year, 93 households purchased their first home. The median price with these mortgages was $60,000 or 67 percent of the new housing purchase price that was imposed under the law, so Pittsburgh got in substantially below the requirement.

I understand the committee's concern that State and local agencies' MRBs have an impact, and these Federal revenue bonds and their authority needs to be periodically reviewed. We don't quarrel with this. As a matter of fact, we offer ALHFA's assistance in your efforts. The members of ALHFA are certain that providing quality household housing at an affordable price is one of the most useful and finest services our tax dollars can provide.

I welcome any opportunities to respond to your questions and urge you to report out favorably H.R. 1176.

[The prepared statement follows:]

STATEMENT OF BERNARD L. TETREAULT, PRESIDENT OF THE ASSOCIATION OF LOCAL HOUSING FINANCE AGENCIES

SUMMARY

1. The Association of Local Housing Finance Agencies supports H.R. 1176.
2. Purchasing a home is an expensive undertaking out of the reach of many American households.
3. In the last four years, a period of record-high interest rates, single-family mortgage revenue bonds have facilitated homebuying for many households which would otherwise have been unable to afford conventional mortgages.
4. The Mortgage Revenue Bond Act of 1980, Public Law 96-499, has limited the use of single-family bonds exactly as Congress intended.
5. Many ALHFA members have model single-family mortgage revenue bond programs.
6. Local housing finance agencies provide a special kind of experience and accessibility to the homebuyers they serve.

STATEMENT

Good morning. Mr. Chairman and members of the Committee. My name is Bernard L. Tetreault. I am Executive Director of the Housing Opportunities Commission of Montgomery County, Maryland, and I serve as President of the Association of Local Housing Finance Agencies (ALHFA). I am here today to testify in support of H.R. 1176, the Housing Finance Opportunity Act of 1983 as introduced by Representative Thomas Downey (D-N.Y.) and Representative William Frenzel (R-Minn.) and cosponsored by 315 members of the House of Representatives.

ALHFA represents housing agencies in every region of the United States. Our members include agencies in rural areas, suburban townships and large cities. Some ALHFA members have responsibility for all aspects of community development while others supervise only housing finance programs. We have a diverse membership, with one common goal: to provide high quality, affordable housing for some of those who are otherwise unable to purchase homes.

For most Americans, owning a home is a life-long dream, but a very expensive one; it often represents a prospective homebuyer's largest—and frequently only—investment. Ordinarily, financing that investment is the most significant impediment faced by the purchaser. It is difficult for anyone to buy a house, but for those with low and moderate incomes, it is virtually impossible to afford the costs associated with ordinary mortgages.

The need for this legislation is evident. In 1979, an annual income of $25,523 was needed to qualify for a 10.78 percent 30-year fixed rate mortgage to purchase a house at the median price of $56,825. In 1982, when mortgage interest rates were much higher—15.14 percent—the median house price had risen 20 percent to $68,185, while the income needed to purchase the home rose 36 percent to $34,795.

This year, the interest rate has fallen to 13.5 percent, but the median purchase price is expected to be $70,000, a 3 percent rise. To qualify for a mortgage, one needs an income of $38,485 or an additional 11 percent income.

Thus the cost of housing has increased 23 percent, but the income necessary to qualify for financing has increased 50 percent.

Single-family mortgage revenue bonds (MRBs) can help to alleviate this problem. In the late 1970's, many individuals who otherwise might have been able to buy homes were frozen out of the market by the combination of high interest rates and inflation. "Good buys" in housing became increasingly difficult to find.

In 1979 and 1980, the Congress had an opportunity to eliminate this program when it considered the Mortgage Subsidy Bond Tax Act (Public Law 96-499), but it chose instead to impose purchase price limitations on single-family bond programs in the hope that issuance of the bonds would be reduced but remain available for those who most deserved to benefit from them. Congress' action accomplished exactly that: the use of single-family mortgage revenue bonds has been targeted largely to low and middle income families since 1980.

Congress also forced a comprehensive review of the program by establishing a "sunset" of the program on December 31, 1983. ALHFA believes that the current review of the use of single-family mortgage revenue bonds will reveal the solid accomplishments of state and local agencies in providing affordable housing for those who need it.

Local housing agencies have been responsible providers of home financing at a time of inordinately expensive homes and mortgages. In the last two years, we have collectively helped in the purchase of 73,000 homes. Survey data from our members suggests the median income of a program beneficiary was $29,213 or 107 percent of our jurisdictions' area medians—nearly $10,000 less than the average homebuyer's 1981 income of $39,100. A compilation of local issuers' volume (Exhibit A) is at the conclusion of my remarks and I ask that it be printed in the hearing record.

There is a special satisfaction working in a local agency and dealing so personally with the people we serve. I have met many prospective homeowners in my twelve years in community and housing development. In Montgomery County, Maryland, nearly 3,500 households have purchased homes through HOC single-family mortgage revenue bond programs. The availability of these mortgages also stimulated the construction of over 2,300 new single-family homes and the rehabilitation of another 400 housing units.

These mortgages went to households with income averaging $24,160, less than 61 percent of Montgomery County's median income of $39,800, which is the highest median income in the United States. While the average sale price of a home in Montgomery County is $111,545, the average MRB-financed home is only half of that—$55,576; and that price is only 51 percent of the new housing purchase price limitation imposed by Public Law 96-499.

I believe it is fair to say that without exception, the purchasers of these homes could not afford to buy a house in Montgomery County without the mortgage revenue bond program. Their income are limited and most of them had been looking for a home for some time.

Our experience in Montgomery County is echoed in other cities represented by ALHFA members. Look, for example, at Chicago, which has a small but effective program. Under Public Law 96-499, the purchase price limitation for single-family bond programs in Chicago is $88,400 for new housing and $74,900 for existing housing. The Chicago Department of Housing believes that there are many other individuals and families in the Chicago area who want to own their own homes but cannot afford to do so; these families could be helped by single family MRB financing if the program is continued.

Single-family bonds play an important role in financing first-time home purchases and in rehabilitating deteriorating neighborhoods in many of our cities. For example, the purchase price limitations in Pittsburgh, Pa., another one of ALHFA's member cities, is $90,600 for new housing and $55,000 for existing housing. The Urban Redevelopment Authority of Pittsburgh issued bonds last year which assisted 93 households in the purchase of their first homes; the median price of homes purchased with these mortgages is only $60,555 or 67 percent of the new housing purchase price limits imposed under Public Law 96-499.

There is another aspect to the Pittsburgh program I should like to bring to the attention of this Committee. Paul Brophy, Executive Director of the Urban Redevelopment Authority of Pittsburgh, is one of the leading innovators in our nation's urban renaissance. In parts of Pittsburgh, MRB loans are available to rehabilitate houses in virtually uninhabitable structures in the city—and for these renovation projects, no income limits are imposed. The program is enormously successful, and popular as well. Surely this is an excellent use of tax-exempt finance: renovating an old downtown by attracting not only commercial and industrial activity, but residential development, too.

I understand this Committee's concern that state and local programs which have impact on federal revenues warrant periodic review. We do not quarrel with Congress' responsibility and duty to be absolutely certain that federal revenues are foregone only for useful purposes and fine causes.

The members of ALHFA are certain that providing quality housing at affordable prices is one of the most useful and finest services our tax dollars can provide. I welcome this opportunity to respond to your inquiries, but I urge this Committee to report H.R. 1176 favorably and without amendment.

ALHFA does not say home ownership is an inalienable right, but it is certainly an integral part of the average American's life, liberty and pursuit of happiness.

Thank you, Mr. Chairman.

EXHIBIT A

LOCAL ISSUANCE OF SINGLE FAMILY MORTGAGE REVENUE BONDS[1], 1979–82

[In millions of dollars]

State	1979	1980	1981	1982
Alaska	89.6	0	0	0
Arizona	0	133.0	0	164.9
Arkansas	572.4	204.7	0	30.8
California	732.3	1,067.7	237.7	1,102.1
Colorado	413.5	322.9	251.2	155.5
Connecticut	0	10.6	0	0
Delaware	146.0	90.0	0	50.0
Florida	0	628.8	382.5	215.9
Georgia	0	0	0	155.2
Illinois	448.2	51.8	20.0	101.1
Indiana	0	8.5	0	0
Iowa	20.0	0	0	0
Kansas	169.7	496.2	382.4	156.2
Kentucky	119.4	0	0	48.2
Louisiana	743.3	506.1	0	49.2
Maryland	56.8	68.0	140.9	128.1
Michigan	0	14.0	0	0
Minnesota	162.9	67.3	120.0	66.3
Missouri	0	0	0	71.0
Mississippi	15.0	0	0	0
New Mexico	113.7	31.6	20.2	0
North Dakota	9.0	0	0	0
Oklahoma	236.6	579.9	0	0
Pennsylvania	23.5	13.3	33.0	33.0
South Dakota	0	62.1	0	0
Tennessee	0	200.3	0	0
Texas	184.5	889.5	0	455.3
West Virginia	347.0	115.3	0	0
Total	4,603.4	5,561.6	1,587.9	2,982.8

[1] Note.—No single family mortgage revenue bonds were issued by local agencies in the followng states: Alabama, District of Columbia, Hawaii, Idaho, Maine, Massachusetts, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New York, North Carolina, Ohio, Rhode Island, South Carolina, Utah, Vermont, Virginia, Washington, Wisconsin, and Wyoming.

Chairman ROSTENKOWSKI. Thank you. Mr. Millsap; you may proceed.

STATEMENT OF WAYNE L. MILLSAP, CHAIRMAN, MISSOURI HOUSING DEVELOPMENT COMMISSION, PAST CHAIRMAN, NATIONAL CONFERENCE OF STATE HOUSING AGENCY CHAIRPERSONS

Mr. MILLSAP. Thank you, Mr. Chairman. I want to thank you, Mr. Chairman, because of your tolerance in letting me buttonhole you to talk about MRB at the Palm Restaurant when I was last in town. If I embarrassed you when I buttonholed you, I want to take this opportunity to apologize, but I know how much time and concern you have given this problem.

I also want to take the opportunity here to thank Congressman Rangel and Congressman Duncan, and especially Congressman Frenzel and Congressman Downey, for their special interest and concern with the work that we are doing with the State housing agencies.

Mr. Chairman and members of the committee, my name is Wayne Millsap, and I am the chairman of the Missouri Housing

Commission. My commission was created under Missouri law in 1969. My commission is unique among the State housing finance agencies in that the Governor, the attorney general, and the State treasurer, who are all elected officials of the State of Missouri, are named as full voting members of the commission. I am also pleased to report to you that all these officials are active in the work of our commission. Six other members of the commission are, like myself, citizens who have demonstrated an interest in or knowledge about low- and moderate-income residential housing in our State.

Since our agency was created it has issued nearly $1 billion in tax exempt bonds to provide housing for low- and moderate-income people in Missouri. Like most States, Missouri has helped to finance much of the Federal housing programs in recent years. They have been financed by funds obtained by State housing finance agencies on the open market through the sale of tax exempt mortgage revenue bonds. More importantly, perhaps though, our agencies have provided mortgage moneys for low- and moderate-income citizens to fulfill the dream of having their own home. It is our sincere belief and conviction that hundreds of thousands of families now occupy homes financed by our agencies throughout the country who would not otherwise have been able to obtain alternate financing from any other reasonable source. As members of this committee know, the theme of our agencies this year in attempting to convince the Congress and the administration that we should continue our work is "Don't let the sun set on the American dream." To us, this is more than just a hollow cliche.

Last year I had the honor of serving as the chairman of the National Conference of State Housing Finance Chairpersons. This assignment took me from one end of the country to the other while I visited with the administrative personnel and members of commissions and authorities. I found dedicated members committed to the rather clear goals and purposes which have been spelled out in the laws that created these agencies—to provide housing finance assistance for low- and moderate-income citizens.

Gentlemen, we have in place in the United States today active functioning State housing finance agencies in 49 of our 50 States. In addition, there is a plethora of local housing finance agencies which also have been given authority to issue tax-exempt bonds for low- and moderate-income housing finance. Our agencies are close to the people. We are delivering housing finance every day.

Those of us who took the concept of the "New Federalism" to heart concluded we were the proper suppliers of or conduits for mortgage finance funds for low- and moderate-income citizens who are priced out of the private market. We believe our ongoing role in the mortgage finance field is so important and so valuable that we should now be in negotiation with the Federal Government as to how our roles could be expanded instead of being here pleading for the continued right to do the business we were designed to do—supply mortgage financing for low- and moderate-income citizens on terms they can afford.

It should be no surprise to this committee that the continuation of our well-proven, well-established method for creating and supplying mortgage funds for low- and moderate-income citizens has the support of the National Governors Association, the National

Council of State Legislatures, and the U.S. Conference of Mayors. You also know that the homebuilders, the realtors, and the mortgage bankers fully support our ongoing work.

I am familiar with the arguments that have been offered to this committee by Treasury, GAO, and the CBO, and I am not the economic expert who should answer this, but I will say there is not a program up here that does not cost money. I suggest to you to look closely at the benefits and see if as we do you do not find that they far outweigh the minimal costs on Treasury income, the housing, the jobs, the taxes.

To me the overriding consideration this committee and the Congress and the administration must face is that local and State units of government are already heavily involved in helping to provide mortgage financing for low- and moderate-income citizens. We have in place effective, operating agencies of government, most of which have heavy involvement by elected officials responsible to the citizenry.

I would hope that this committee can give prompt approval to H.R. 1176 and that this administration commence a dialog with State and local government as to how and to what extent they might increase their role in helping supply the housing requirements for our citizens as we approach the 21st century.

I am pleased to tell the committee that I have in my prepared remarks some innovative things our commission has done in Missouri. I ask that they be looked at showing how we have responded to problems in Missouri like the Times Beach flooding and gave assistance to the people there with low-cost mortgage loans and other things. In our State our Governor has taken a lead, Governor Bond, in the Governors Association. I think it is reflective of the strong support from the Governors Association as Chairman of the Community and Economic Development Committee. Every member in our State congressional delegation, Senator Danforth, who is on the Finance Committee, is working hard for us, Senator Eagleton, a Democrat, six Democrats, three Republicans, all are in support of H.R. 1176.

Thank you, and we hope that this committee will also promptly report it out.

[The prepared statement follows:]

STATEMENT OF WAYNE L. MILLSAP, CHAIRMAN, MISSOURI HOUSING DEVELOPMENT COMMISSION, ST. LOUIS, MO.

Mr. Chairman and members of the committee, my name is Wayne L. Millsap and I am the chairman of the Missouri Housing Development Commission. My commission was created under Missouri law in 1969. My commission is unique among the State housing finance agencies in that the Governor, the attorney general and the State treasurer, all elected officials of the State of Missouri, are named as full voting members of the commission. I am also pleased to report to you that all these officials are active in the work of our commission. Six other members of the commission are, like myself, citizens who have demonstrated an interest in or knowledge about low and moderate income residential housing in our State.

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Gentlemen, we have in place in the United States today active functioning State housing finance agencies in 49 of our 50 States. In addition, there is a plethora of local housing finance agencies which also have been given authority to issue tax exempt bonds for low and moderate income housing finance. Our agencies are close to the people. We are delivering housing finance every day.

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It should be no surprise to this committee that the continuation of our well-proven, well-established method for creating and supplying mortgage funds for low and moderate income citizens has the support of the National Governors Association, the National Council of State Legislatures and the National Conference of Mayors. You also know that the home builders, the realtors, and the mortgage bankers fully support our ongong work.

I am familiar with the arguments that have been offered by Treasury, GAO, and the CBO. There may be some cost to our programs but these costs are outweighed by the benefits—housing—jobs—taxes. This committee which has the responsibility of raising the funds needed to operate the Federal Government properly must eye every expenditure and drain on the Treasury very carefully. This I would say to you, however—there is some cost but the exact amount of that cost can never really be determined and the estimates are varying across the field from the exaggerated estimates of the Treasury to other economists who project far less tax revenue loss.

To me the overriding consideration this committee and the Congress and the administration must face is that local and State units of government are already heavily involved in helping to provide mortgage financing for low and moderate income citizens.

We have in place effective, operating agencies of government, most of which have heavy involvement by elected officials responsible to the citizenry. An important and good job has been done by these agencies. This role is too important to be extinguished on the theory that the Treasury might collect more taxes if there were not so many tax exempt securities in the marketplace.

I would hope that this committee can give prompt approval to H.R. 1176 and that this administration commence a dialog with State and local government as to how and to what extent they might increase their role in helping supply the housing requirements for our citizens as we approach the twenty-first century.

Most of our agencies are strong. Most of our agencies now have developed reserves which are being used innovatively to assist in many areas of housing need. Let me give you just a few quick examples of things we are doing in Missouri:

1. NEIGHBORHOOD REHABILITATION

We have made available a revolving fund or more than ten million dollars for establishing neighborhood organizations in our urban areas to utilize for the purchase and rehabilitation of deteriorated properties.

2. DISASTER RELIEF

When the Times Beach disaster occurred in Missouri our housing commission immediately responded to the Governor's call for assistance and did the following:

Apartments

A. Utilized recaptured section 8 units so that over 300 apartments with 20 percent subsidized could be made available in the areas adjacent to Times Beach.

Reduced rate mortgages

B. Special low rate mortgages for up to 10 years with rates as low as 4 percent per annum were offered to Federal Emergency Management Administration certified eligible recipients. We now anticipate that we will have financed three and a half million dollars in special assistance loans to these distressed families.

Home improvement loans

C. A two million dollar special new allocation of "weatherization loans" for home improvements were made available for the general area involved in the flooding that preceded the dioxin exposure.

3. HOMELESS HOUSING

Recognizing the need in our ever-changing society for additional aid for the homeless our agency at the Governor's request allocated one-half million dollars for obtaining housing units available for the homeless. Our agency has contracted with the St. Louis Housing Relocation Center for the acquisition of properties that will be made available for the homeless in the St. Louis area and a similar program is being initiated in Kansas City and other major cities in our State.

I could go on and on with the service of our housing finance agencies in this country. I hope these examples will show this committee that our agencies are recognizing the housing needs and are acting to fulfill these needs as responsible agencies of State and local government.

In conclusion, I am happy to say to this committee that Governor Christopher S. Bond of Missouri is chairman of the Committee for Economic Development of the National Governor's Association and has taken a leadership role with the NGA which reflects the overwhelming conviction of our Nation's Governors that the program be continued. Both our U.S. Senators, Thomas F. Eagleton, Democrat, and John C. Danforth, Republican, are supporting our efforts. Senator Danforth is a member of the Finance Committee where S. 137 has already been approved as a companion to H.R. 1176. Every Member of our congressional delegation in Missouri—6 Democrats and 3 Republicans support this program. We are especially pleased and proud in Missouri that Congressman Gephardt is serving as a member of this committee. He distinguished himself as a leading citizen in Missouri before he came to Congress and and he has certainly added more luster to his record in the House and as a member of your committee.

We sincerely hope you will move quickly and decisively to show your support for what we are doing to supply needed mortgage funds for low and moderate income citizens on the State and local level.

Chairman ROSTENKOWSKI. For purposes of discussion, I would like any one of you or each of you to comment on the following possible revisions to the substantive provisions of the mortgage bond program: one, eliminating the $200 million lower limit on State volume caps; two, placing veterans housing bonds within the volume cap; and three, imposing income restrictions at 100 percent of the area median income. Would any of you like to comment?

Let me just preface your response. You are all experts. We would like you to participate in this discussion. If we do not receive the input of technicians such as yourselves, we make mistakes when we write the law. So I feel that my discussion question will give us some guidance. As you can recognize, there is a feeling that some additional restrictions should be enacted.

Mr. Ritchie, would you like to comment?

Mr. RITCHIE. Mr. Chairman, dealing with those in the reverse order, first with regard to the income limits, let me say that the difficulty that I see with the income limits are several. First, with the fluctuating interest rate climate in which we exist today, it is extremely difficult to determine an income limit which will be suitable when interest rates, as they did last fall, dropped 400 basis points, when it would be much too high, or when interest rates rise several hundred basis points in a matter of months. I think that the suggestion of setting limits needs to be attuned to the reality of our economy today. Since 1979, we have seen interest rates move in a quite dramatic fashion in comparison with the past. In addition, and I realize this may not be comfortable information, but quite frankly, the information available in Washington on median incomes, is very inaccurate and scant. We find working with that to be extremely difficult, first to find it, second to keep it up to date. Finally, we find that when an agency that is opposed to this program such as Treasury gets into the business of developing the regulations as to how the income limits are going to be effected, they can frequently shut down the program through their regulations for an extended period of time. This is what happened to us when sales price limits were selected. Now sales price information is perhaps more available than income information, and yet that shut down our programs for almost a year while we attempted to get accurate information on sales prices and accurate needs in determining what those sales price limits were. So that to add a limitation that goes to the heart of the program such as income limits we believe has the potential of creating a great deal more redtape, shutting down the program for a time and creating a rigidity in the program that would not be commensurate with the economic conditions in which we live.

Looking at the next question of veterans bonds, when the Ullman bill was considered it was the determination of this committee and the Congress at that time that veteran bond programs should be excluded from the Ullman considerations. The rationale at that time, I think, would still be applicable. We do not have a veterans bond in Virginia, but in the States in which those programs are operative, they have been operative for several decades and have become a very major part of the housing industry in those States. It would have a very serious impact, I am sure, on the housing industry in the States to eliminate those programs and that would be the effect of including them in the cap.

The theory on the cap, of course, is that these programs actually cost the Federal coffers revenue dollars. We do not necessarily accept that analysis. I heard in a public meeting several months ago the former chief of staff of the Senate Budget Committee states that—the economic model the Treasury uses is a static economic model that would be a joke if it were not being used by the Federal Government. It does not take into consideration the economic activity and the revenues that are generated by programs such as ours. And we believe that if those revenues were considered also in an economic model, that we would find that these are actually net gainers for the Federal Treasury, and that the concerns about loss of revenue that are suggested, which prompt the suggestion of a limit on the volume of the bonds, are not necessary.

Chairman ROSTENKOWSKI. My time has expired.

Mr. Rangel will inquire.

Mr. RANGEL. What was the question you wanted to ask? I yield to the Chair.

Chairman **Rostenkowski**. Would someone like to comment on the $200 million lower limit on State volume caps?

Mr. **Tetreault**. I would like to address point 3.

Mr. **Ritchie**. Let me add a point on the limit. I think the same points I made with regard to revenue loss are applicable in that the limitation assumes that these programs are revenue losers, and I do not accept that analysis. I think these programs actually generate net revenues for the Treasury. In addition, I think that the 9-percent limit that we have at the present time, that is 9 percent of $200 million is serving only a portion of the families who need this assistance today.

Mr. **Ford**. I might also point out that there are some very real market conditions at work in terms of the ability of any State agency to issue these bonds. In other words, when we go to market and sell these mortgage revenue bonds, obviously at some point we are going to have to have mortgages available as a security for these bonds, and there must be a demand. We are finding in New York State where we are anticipating a bond issue of $200 million that we have assessed on our initial assessment of demand throughout the State is close to half a billion dollars for those moneys. If that demand was not there we would not have a marketable product in the first place, and I think it is important to point out that we are not in the business of issuing bonds just for the sake of that process somehow, but in order to provide a substantive and meaningful service to the citizenry that depends upon our activities.

Mr. **Rangel**. Mr. Ford, you have done a remarkable job in the short time that you have been with the State. How do you respond to the criticism that mortgage revenue bonds tend not to service people of low and moderate income but are used by individuals who do not really need this type of help?

Mr. **Ford**. We would respond in a couple of ways to that. First of all we do have a targeted areas program which deals with those areas of chronic economic distress and they are described in my written testimony. Fully 20 percent of the funds that are derived as proceeds from these bond sales are targeted or allocated for these areas. We have endeavored to give priority to new construction which tends to service and provide greater activity in areas where we would see low-income residents in the first place. For example, in the city of New York we find that we will not see as many single-family freestanding homes as you might in other States. There we have endeavored to get involved in more creative and innovative activities involving cooperative projects and there are a couple of cooperative projects in which we have been involved in Brooklyn and in the Bronx where the purchase range has been between $20,000 and $40,000 in one instance in Brooklyn and between $32,000 and $56,000 in the Bronx in cooperatives.

Mr. **Rangel**. I asked the question because I am familiar with the work that we are doing in New York. Do the other witnesses have similar testimony that they could submit for the record to show that they have been using these bonds not just for the wealthy, who really do not need any help, or not just for those that want to buy more expensive second homes? There was a rather severe attack made on the entire program, and I think what we need is not a good program for those in the business of developing housing or arbitrage or selling bonds, but to show what your track record is in terms of either the income of the new or now second home buyer, or the area in which you are encouraged, through providing this mortgage relief, to buy or to build.

Mr. TETREAULT. I can do that for the membership of the Association of Local Housing Finance Agencies.

Mr. RANGEL. It seems to me that a rather severe attack has been made and I am rather shocked that the administration is concerned about what the income cap is going to do to middle income and they are also concerned that this program is not helping the low and moderate income. Yesterday the Assistant Secretary of HUD announced that there is a building program going on throughout the United States, and he would hope that rather than give these very expensive subsidies, we just give the President's economic recovery program a chance to let the boom continue. Do any of you come from any villages or towns that have seen this boom?

Mr. FORD. Mr. Rangel, during the past 2 weeks I have had the occasion to travel throughout the State of New York describing our upcoming forward commitment program. I have been in Rochester, Buffalo, Syracuse, and Albany, and other members have been in Plattsburgh, White Plains, and Hauppauge, and almost universally the product which we propose to have available, that is the low-interest mortgage financing, has been seen as a tremendous aid and assistance from the builders associations and community development individuals and community leaders, and also the banking community. I also point out that we have a first-time homebuyer requirement and as well we have certain purchase price limits which tend to keep the wealthy people who do not need this kind of help out of our program. We do waive the first-time homebuyer requirement in our so-called targeted areas because in those instances we would trade off, if you will, in terms of having people purchase homes in areas that need that type of growth and development. But I respectfully suggest that the information that we have and would continue to provide would show that this program is providing a real service for people in need, and without that program people will not get that service and their needs will not be addressed.

Mr. RITCHIE. With the chairman's permission, I hope the other witnesses would have the opportunity to place similar information into the record.

Chairman ROSTENKOWSKI. Without objection.

Mr. Downey will inquire.

Mr. DOWNEY. I have a series of questions on the amount of money that actually goes for mortgages versus that which is consumed by lawyers, bond salesmen, and others. The Treasury says that $2 out of every $3 goes for mortgages, Alice Rivlin says basically $1 out of every $2, GAO says that 87 percent goes for mortgages. How much of the bond money actually goes for mortgages?

Mr. RITCHIE. Today about 93 percent of the money goes for mortgages. A portion of the remainder is used for reserves, roughly 5 or 6 percent, and 2 percent may go for the cost of issuance, the fees for the investment bankers, the attorneys, and so forth.

Mr. **Downey**. Ninety-three percent; is that pretty much the agreed upon figure?

Mr. **Ford**. That would actually be available for the mortgage financing itself.

Mr. **Downey**. I am delighted to see someone who looks younger than I before the committee, professor. I would like you to expand on how your analysis differs from that of the GAO and the Treasury about how much financing tax-exempt bonds costs the Treasury. I think it is an important point here that needs to be emphasized. I have read your analysis. I would appreciate it if you would explain it once again for me and those of the committee that are here.

Mr. **Kormendi**. As you recall, yesterday when you were questioning Mr. Chapoton, you asked him about what sort of portfolio adjustments the Treasury takes into account when they do their analysis. He paid lip service to the fact they take some portfolio adjustments into account, but it ends up being exactly the same as when they assume a direct substitution of tax-exempt for taxable financing. They have never, however, made public in any way any figures relating to explicit portfolio readjustment. They have, in fact, proceeded as if when a new issue of mortgage revenue bonds are put on the market, the relevant substitution would be people directly giving up taxable bonds to buy these tax-exempt bonds.

In fact, all the available data and all the relevant and current theories of finance concerning portfolio holdings recognize that the relevant substitute for a tax-exempt bond is partially taxed assets, tax-preferred assets such as equity. The tax implications of taking into account the full spectrum of portfolio adjustment will yield much lower tax estimates.

The way the portfolio adjustment works is that a new issue of tax-exempt bonds comes onto the market and the people who absorb them are generally the high-tax-bracket individuals. But they do not give up taxable bonds, of which they hold very little, they give up equity. Because of considerations of deferment of capital gains and because of the fact that the tax treatment is much lower on capital gains, the actual taxes paid on equity is much lower. Instead of the 40 or 50 percent paid on ordinary income, scholars have estimated that the taxation on equity, once deferring and reduced taxation is taken into account, may be more on the order of 10 percent for these high-tax-bracket people. So in fact at the upper bracket spectrums the tax loss to the Treasury is 10 percent.

Now, that equity has to be absorbed someplace, and it has to be absorbed where people have the capability of giving up taxable bonds and absorbing equity. That is at the lower end of the tax-bracket spectrum. Since the average tax bracket of low bracket investors is on the order of 10 percent, then paying 5 percent on the equity is a 5-percent differential. Added to the 10 percent at the upper brackets, the total comes out to about 15 percent, or about half of the 30 percent the Treasury would assume. The one important thing the Treasury does not take into account in this regard is that there are so many nonprofit institutions, pension funds, holding both taxable bonds and equity. When these institutional investors make their portfolio adjustments, there are no tax considerations at all.

Mr. **Downey**. I am curious to know your view of what Senator—the senior Senator from the State of Wisconsin, I think I can refer to him that way here, has placed an income—he has an amendment for an income cap. Can you address what impact you think that would have to this program, and in particular what it would do to our State?

Mr. **Ford**. We think it would provide difficulties in the State of New York in that the median income cap proposed by Senator Proxmire would place some very artificial restrictions on the program. We believe that the purchase price limits and the first-time homebuyer requirements give us an effective limitation on the program's activities so that we do address the needs of the low- and moderate-income families throughout the State. As Mr. Ritchie pointed out, the volatility of interest rates is such that the income limits alone would, in fact, really make the program a lot less predictable, certainly with the various fluctuations that we see in interest rates, so that we really would not be able to target our program so as to provide the kind of direct service that is necessary.

Mr. **Millsap**. We calculated that of the 150,000 homes last year financed through our programs, half of those programs, at least if you went on 100 percent of median income, half of those buyers could not have participated in the program last year.

Mr. **Downey**. Thank you. I want to read into the record if I might:

> In 1982 half of all FHA-insured loans went to households earning more than 140 percent of the national median income, and given the interest rate reduction obtained by mortgage revenue bonds, it is unreasonable to expect that a severe income cap of 100 or 120 percent of area median would be workable.

which I think supports the information that you have just given us and that we have heard before. This non compos mentis testimony from the HUD Secretary yesterday was simply that. The idea that there are other programs out there that afford subsidies for the Federal Government that people can take advantage of is mythology. And this is the only game on the block and the only train leaving the station. If you want to get a house you better be on it.

Mr. **Millsap**. There may be other programs that are coming down the pike, and there may be better ways of delivering housing to low- and moderate-income people then the way we are doing it now. But we do not know where these program ideas are coming from in this administration at the present time. We know that we are supplying housing for the people, and until something is clear and definite out there, I do not think you can take the risk of terminating this program.

Mr. **Downey**. What is the view of the impact of mortgage bonds on the municipal bond market in general?

I want to address a concern that the chairman voiced the other day, that with IDB's and mortgage revenue bonds and all the other bonds, that this raises the price for things like roads and sewers and bridges to a higher level to the same taxpayers that we may be wanting to help.

Mr. **Ritchie**. First, Congressman Downey, there is a cap on the volume of bonds which can be sold in any single year. We calculate that that would mean that these would not be more than 2 percent of the municipal bonds in the market in any single year. We don't believe that is going to have a severe impact.

In addition, the calculations made by the Treasury as to the impact have been revised and I believe are now in line with Professor Kormendi's estimates as to that impact, and it is, I think, a matter of a few basic points.

Mr. **Kormendi**. The main consideration is the same. Since you have an overall integrated capital market, instead of a very narrow group, that is, those at the marginal tax bracket of 30 percent, to absorb the bonds, there would be a negligible interest rate impact. In fact, the data reveals that it is only 6 basic points.

Mr. **Downey**. I would ask Mr. Pickle, who had this concern yesterday, that we just have so many various estimates about the impact of revenue bonds, I would hope that Professor Kormendi's work and also that of Professor Nagle be considered in any new way that we look at this. It is probably because I agree with Professor Kormendi that I think he is right, but the fact is that some of his analysis is persuasive to me, and from what I heard from Mr. Chapton and from others, I think that we may be misreading the way tax-exempt finance impacts on revenue estimates.

I hope that his analysis is given some scrutiny.

Mr. **Ford**. On that point, congressman, I just wanted to briefly take this occasion to comment on the revenue loss issue. I don't believe it is possible to look at the whole question of how much money may be lost to the Federal Treasury with respect to tax-exempt mortgage revenue bonds without looking at the so-called multiplier effect of our activities. Whether it is the 250 pounds of nails that is the average that goes into every new home that is built or the washer or dryer people buy for the new home, whether newly built or existing, whether it is the 10 gallons of paint, all of these things result in taxes being paid, result in jobs being available so that other people can work and pay taxes.

I don't know that anyone is really capable of calculating the full multiplier effect. All we can tell you is that without the ability of people to purchase homes and continue that type of activity in the housing market, which is one of the major foundations of any coherent, cogent and consistent economic development plan, you won't have these revenues available to the local, State or Federal Government.

Mr. **Downey**. I would like to ask a question raised by Mr. Moore and some others, that what we need to do is rely on the marketplace when times are good and then have a trigger for this program when times are not good.

Would any member of the panel care to address the question of whether or not a trigger mechanism for this would be a workable plan?

Mr. **Ritchie**. The first effect would be that the programs only serve the upper income people that they reach. It would only be triggered at such times as 1982 when we are serving the highest income people that we serve, and we would never serve the lower income people when rates are lower. There is a very real need that these people have for this program.

The second effect would be to make impossible the existence of agencies like my own and the other 48 States, which have agencies, because we can't call the people in to do the work when the trigger is activated, and then send them home for 9 months until the trigger is activated again. So it just makes impossible a rational continuing program. In fact, it would cause, I think, the sort of boom and bust—just accentuate the boom and bust cycles of the housing industry if we use that approach.

Mr. DOWNEY. One of the purposes of the revenue bond program was to provide a countercyclical stimulus to housing at the time when we need that stimulation; other responses to the notion of a trigger.

Mr. MILLSAP. I would say this about the trigger: I don't mean to be facetious, but I think it might be comparable to having the Budget Committee trigger the activities of this committee or something of that sort. You have your responsibilities here and we have our responsibilities out there, and, as Mr. Ritchie says, we have an ongoing function. We have staffs of people functioning all the time. The need is there all the time.

We have seen good and bad for the last few years—maybe more recently—but during all that time the need is there. There isn't going to be a time when there isn't a need. No matter what the economists said yesterday about the economy is going to take care of everything, that is not so. There will always be people who need this kind of assistance.

Mr. FORD. In New York City, there are two areas considered to be very famous because of serious problems—South Bronx and East New York in Brooklyn. In both of those areas right now we are, with the State of New York Mortgage Agency, working with developers and the city agencies that are responsible for putting together housing projects involving some 3,000 homes in East New York with the council of churches there, and the Charlotte Gardens project with the South Bronx development organization. I can assure you that if this program did not exist, it is very doubtful that these programs would be able to provide the kind of affordable housing that is predicted during the next year.

Certainly with the decline in interest rates, that is the only reason why we are able to step up to the plate, if you will, and be of help to some of these projects, which we plan to do with the support of the legislature and the Governor's office.

Mr. DOWNEY. That is a good point; that as interest rates decline, the opportunity for people of lower incomes to be able to get houses increases, and that is just a very——

Mr. TETREAULT. We have taken families from our public housing program who have been in a rental situation for 10 or 12 years and put them into their own homes. When they get to a point where their income has increased, we can provide 7¾ or 8⅞ percent mortgage loans from our portfolio. We can't do that when the interest rates are 13½ or 14 percent.

Mr. DOWNEY. Thank you, Mr. Chairman.

Mr. PICKLE. Thank you, Mr. Downey.

I thank the panel. I was not here for all the statements and the questions.

I was interested in the statement that the chairman posed to you about your views on certain limitations or possible changes in the program. I think that your answers should be reviewed carefully and the statements that you have made at the request of Mr. Downey ought to be considered by the whole committee. We think you have made valid points and they ought to be reviewed as we consider this package.

I make the observation to you—not for purposes of arguing—but when you use an example that if an authority issues $100 million in mortgage revenue bonds, that $93 million of that would go into housing and the balance of about $7 million would go into the costs and the reserves, and that is perhaps a good, valid point to make, to start with. But the real question when you do that is, what does that cost the Federal Government in the way of loss of revenues or in overall costs? What is it actually going to cost the Federal Government if you enter into those kinds of programs?

You have to ask yourselves how much of that money will go to the individual home buyer, who ought to be getting the help, rather than funding going to intermediaries.

Now, the GAO has made an estimate to us and it has been corroborated by the Congressional Budget Office that much more goes to bond attorneys, investment bankers, issuing authorities, financial institutions and the higher tax bracket bond buyers than to the home buyers. The CBO says that the ratio is about 2 to 1. And GAO said, in 1982, it was about 3 to 1.

Now, you tell me that that really doesn't cost us. You don't agree with those figures. We also have to consider the fact that that is what the CBO and GAO is telling us.

So while you make a point that they serve a purpose, you have to ask what it costs the Federal Government and what help is really going to the home buyer, what percentage of that dollar. That is something we have to consider, too. I make that as an observation—not for purposes of argument—because each of you have your own points.

Mr. Duncan?

Mr. DUNCAN. I think you have covered everything since I have been here and before I had to step out. I want to thank the panel. It is very good. We do have a lot of questions and a lot of problems. I hope everything will work out for the best.

Mr. RITCHIE. Mr. Chairman, I appreciate very much the difficulty of your position when you are getting information that is conflicting on important questions like this. We do have a chart that Mr. White, from the Council of State Housing Agencies, could explain very briefly that deals with the point you just raised, if you would like to have that information.

Mr. PICKLE. I don't think we need the chart. We don't have enough members to see it. But I would like it to be a part of the record. We would be happy to receive that as a part of the record.

We thank the panel very much. Thank you for your testimony.

Now we ask Mr. David Arnspiger and Mr. George Phillips to come forward as members of the next panel.

We are glad to welcome now Mr. David Arnspiger, chairman of the Federal Legislation and Regulation Committee of the Westcap Corp., of Houston, Tex.; and we are glad to have Mr. George Phillips, president of the Council of Hospital Finance Authorities, I presume out of Illinois.

Mr. PHILLIPS. I am also the executive director of the Illinois Health Facilities Authority.

Mr. PICKLE. We are pleased to have both you gentlemen.

Mr. Arnspiger, if you would proceed.

STATEMENT OF S. DAVID ARNSPIGER, CHAIRMAN, FEDERAL LEGISLATION AND REGULATION COMMITTEE, PUBLIC SECURITIES ASSOCIATION, AND CHAIRMAN OF THE BOARD, WESTCAP CORP., HOUSTON, TEX.

Mr. ARNSPIGER. Mr. Chairman and members of this committee, I am David Arnspiger, chairman of the Westcap Corp., a securities dealer located in Houston, Tex. I am also a member of the board of directors of the Public Securities Association.

This morning I am here to present the views of the association concerning current trends in municipal finance, H.R. 1176 and H.R. 1635. I will present the summary of our prepared statement and ask that the entire statement be submitted into the record.

Mr. PICKLE. Without objection, it will be admitted.

Mr. ARNSPIGER. PSA represents brokers, dealers, and dealer banks active in the municipal market, U.S. Government and Federal securities market, and the mortgage-backed securities market. We currently have nearly 300 member firms whose offices are located in all 50 States. Last year, our members participated in over 95 percent of the dollar volume of new issues of State and local government securities.

Before specifically addressing PSA's position on H.R. 1176 and H.R. 1635, I wish to urge the Congress against linking action on these two legislative proposals. Each of these proposals should be examined independently and analyzed on its own merits.

Moreover, I note at the outset our Association's strong objection to the fundamental view of some in Federal Government that the municipal securities market represents a form of tax expenditure. The tax-exempt municipal market exists not because of the exemptions of interest income on State and local obligations appearing in our tax code, but because of the separation of sovereign powers between the Federal and State governments appearing in the 10th amendment of the U.S. Constitution.

If our comments today merely serve the function of altering your approach to this market, I would consider PSA's appearance here today as an overwhelming success.

PSA supports strongly adoption of the Housing Finance Opportunity Act, H.R. 1176, a bill that would eliminate the sunset provision for mortgage revenue bonds. This legislation would simply permit State and local governments to continue to finance their own housing finance programs if they so choose. PSA believes that the Congress should adopt this legislation promptly in order to avoid any unnecessary surge in volume which would occur as a natural consequence of the December 31, 1983 deadline.

The use of the tax-exempt obligations to construct low- and moderate-income housing has permitted State and local governments to minimize the cost of financing home ownership. This result concurs with the findings of the President's Commission on Housing that affordability of housing is the chief difficulty facing low-income renters, and I think the previous panel has stated this in depth.

Further, the reflow generated by these programs has been beneficial to local economies and tax revenues at all levels of government, including the Federal Government. Increased construction has resulted in new employment opportunities and increased economic activity by suppliers of the construction industry. This increased economic activity on the State and local level has resulted in tax revenues on all levels of government which otherwise would not have been generated.

It is also worth noting that as interest rates fall along the entire maturity spectrum and conditions in the housing market improve generally, mortgage revenue bonds, because of their built-in criteria, will tend to provide greater benefits and assistance to families on the lower levels of the income scale. These are the types of families who would otherwise not be able to afford homeownership.

With regard to H.R. 1635, PSA believes that the Congress should take a careful and deliberate approach toward enactment of the Industrial Development Bond Limitation Act. H.R. 1635 would impose significant new restrictions on tax-exempt industrial Government bonds, both small issue and exempt facilities—again, I stress exempt facilities—as well as mortgage revenue bonds.

PSA has adopted the following policy toward small issue IDB's.

> The Public Securities Association supports the right of States and local governments to issue tax-exempt securities for public purposes in accordance with the State law. However, PSA believes that the small issue industrial revenue bonds have had an adverse effect on the municipal market and urge the State and local governments to take positive steps to curtail their use.

Our association opposes Federal legislation to restrict the right of State and local government to determine the public purpose for which bonds can be issued. We believe that any Federal action concerning small issue IDB's should be limited only to the tax treatment of direct private beneficiaries of the proceeds of small issue IDB's.

TEFRA adds a number of restrictions concerning IDB's. Among them are the small issue IDB's are scheduled to sunset after 1986. And property finance with IDB's must be depreciated over ACRS recovery periods on a straight line basis.

During the first quarter of this year, small issue IDB volume actually decreased over 53 percent as compared to the first quarter of 1982. Congress should carefully consider the effect of TEFRA and declining interest rates on this reduction in volume. It is submitted that Congress should not approve broad, new legislation concerning IDB's until it is first able to analyze the effect of the recently enacted restrictions contained in TEFRA.

In addition, we object to any legislation that would limit exempt facilities and charitable purpose bonds. We believe that any proposal applied to these bonds represents a form of restriction which comprises the rights of State and local governments to issue tax-exempt securities for traditional public purposes.

Today, municipal finance for such projects by exempt facility IDB's is essential for the construction and redevelopment of infrastructure and facilities necessary for the social and economic wellbeing of all citizens. The fact that private parties may operate or otherwise benefit from these facilities simply reflects the historical practice of State and local governments in providing public works necessary to support and maintain residential communities and commercial and industrial development.

It has been stated that the growing volume of so-called private purpose municipal securities has served to increase yield. However, the evidence does not appear to prove this hypothesis. Although new issue volumes continue at a record pace, the ratio between taxable and tax-free rates actually decreased when interest rates declined in late 1982 and early 1983.

The narrowing of the tax-exempt/taxable yield ratio supports the theory that interest rate spreads between taxable and tax-exempt securities narrow and widen as the general level of interest rates increases and decreases. This theory is predicated on the notion that when estimating the effect of the supply of new debt on yield, demand also should be considered. When an increase in the supply of debt is met with a concomitant increase in demand, yields remain unchanged. This has occurred in the municipal market.

The huge volume of new issues in 1982 and the first quarter of 1983 was well received by investors. Investor demand restricted any potential yield increase in the market.

We also wish to note that at this time PSA has not yet taken a position concerning the provisions in H.R. 1635 that would prohibit IDB financing where obligations are directly or indirectly guaranteed or insured by FDIC, or Federal deposit insurance. However, PSA does oppose the retroactive effective date of the provision.

This practice has had a severely unsettling effect on the market because it creates uncertainty for both State and local governments and investors. Retroactive dating of legislative proposals may effectively accomplish, without congressional consideration or majority vote, the objectives which are sought by the legislation's sponsors merely through introduction. This is because the introduction of such proposed legislation destroys the ability of State and local governments to carry on the financing programs which such legislation would affect.

PSA believes that the municipal securities market has provided States and localities with an efficient and cost-effective mechanism for financing projects deemed by States and local governments to be of public benefit. The market has again demonstrated its strength and vitality by financing a record volume.

More importantly, the municipal market provides States and localities with a much needed source of capital to meet their needs independent of the Federal Government. We believe that this independence should not be sacrificed to the ever-growing demands of Federal budget deficits. Increased tampering with this market by the Federal Government will only reduce its effectiveness and undermine the confidence of investors.

In closing, we would like to reiterate our views that mortgage revenue bond programs of States and localities have provided their benefit to society and proven it and should not be terminated.

Further, we urge Congress to investigate the effect of TEFRA on small issue—I stress small issue—IDB's, and in no way would we favor any further restrictions on exempt facility IDB's.

Thank you.

Mr. PICKLE. Thank you.

[The prepared statement follows:]

STATEMENT OF S. DAVID ARNSPIGER [1] ON BEHALF OF THE PUBLIC SECURITIES ASSOCIATION

INTRODUCTION

The Public Securities Association (PSA) is pleased to submit this statement concerning two significant pieces of legislation, the Housing Finance Opportunity Act (H.R. 1176) and the Industrial Development Bond Limitation Act (H.R. 1635).

PSA represents brokers, dealers, and dealer banks active in the municipal market, U.S. Government and federal agencies securities market, and the mortgage-backed securities market. We currently have nearly 300 member firms whose offices are located in all 50 states. Last year, our members participated in over 95 percent of the dollar volume of new issues of state and local government securities. These same firms also account for the vast majority of secondary market trading activity in municipal securities. Our membership participates in the full range of dealer activities, including small firms dealing in special assessment issues and local financings, multi-million dollar investment banking powers, full service national wire houses, major money market center and regional dealer banks. Our membership also includes approximately 100 associate members (such as bond counsel, accounting firms, and clearing corporations), whose activities are closely related to the municipal bond market. Therefore, we feel particularly qualified to discuss the current state of the municipal securities market and the potential effects of H.R. 1176 and H.R. 1635 on the market.

Before specifically addressing PSA's position on H.R. 1176 and H.R. 1635 we wish to urge the Congress against linking action on these two legislative proposals. Each of these proposals should be examined independently and analyzed on its own merits, for each will have its own distinct and pronounced effects on the municipal securities market.

Moreover, we must reiterate, at the outset of these comments, our strong objection to the fundamental view of Congress that the municipal securities market represents a form of "tax expenditure." The tax exempt municipal bond market exists not because of the exemption of interest on state and local government obligations appearing in our tax code, but because of the separation of sovereign powers between the federal and state governments appearing in the tenth amendment to the U.S. Constitution. If our comments today merely serve the function of altering your approach to this market I would consider PSA's appearance here today as being overwhelmingly successful.

This statement will analyze issues of significant consequence to the future of the municipal securities market, therefore, it seems appropriate to first focus our attention more generally on this market's fundamental characteristics and the present state of the market.

BASIC MARKET CHARACTERISTICS

The municipal securities market is one of the largest capital markets in the world. It is estimated that at year end 1982 there were $450 billion in state and local government bonds outstanding. Volume of new issues in 1982 was a record setting $123 billion in both long and short-term debt. The trend continues in 1983 where long and short term volume for the first quarter of the year was an unprecedented $24.7 billion. (See Tables 1 and 2)

For over a century the municipal securities market has provided states and localities access to low cost capital. This market is large and diverse and has several characteristics which set it apart from other fixed income markets.

First and foremost, the interest paid on state and municipal bonds is exempt from federal income taxes. This Constitutional and until recently Congressionally-affirmed principle enables local governments to borrow at rates substantially below other taxable fixed income rates, and has provided a benefit to society worth billions of dollars. Make no mistake, their tax-exempt status is the key to investor interest in this security. However, recent passage of a provision in the Social Security

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[1] Mr. Arnspiger, who is Chairman of the Board of Directors of the Westcap Corporation, is Chairman of the Federal Legislation and Regulation Committee of the Public Securities Association.

Amendments of 1983 that in effect would tax certain interest earnings on municipal obligations is of great concern to all market participants.

Second, the municipal market has provided municipal investors with a great level of investment safety. The creditworthiness of municipal securities is an important component in their marketability. Their continued financial strength is essential in allowing them to provide capital for public works and infrastructure development.

Third, this market is characterized by a staggering variety of individual issues. Estimates vary, but there are approximately 50,000 political entities that have debt outstanding. The vast majority of issuers sell long-term bonds in serial maturities, each one constituting a separate "issue." For this reason, the universe of outstanding municipal issues approaches 1.5 million. This precludes maintaining continuous two-sided markets in many municipal issues, but most of the infrequently traded credits will find a ready market somewhere in the national network of dealers and dealer banks. There is a very active, sophisticated, and competitive secondary market for most municipal issues.

SOURCES OF FUNDING FOR STATE AND LOCAL GOVERNMENT

State and local governments have three principal sources of raising revenue to finance capital projects. These sources of funds are; (1) tax revenues and user fees, (2) transfer payments from other levels of government, and (3) the sale of fixed-income securities. The current trend to lower taxes and resistance to higher user fees at all levels of government, and a changed perception of the role of the federal government as a supplier of financial support, have curtailed the first two of these major sources of capital. Consequently, the continued health and efficiency of the municipal bond market is of critical importance to enable states and localities to make necessary improvements to infrastructure and public works.

The decision of a state or local government to borrow funds in the tax-exempt market is based on a wide range of considerations. Issuers consider factors such as the need for the facility being financed, the debt burden a community can sustain, the maturity of and prospects for the local economy, and legal restrictions on borrowing. Under our federalist system of government, the decision of whether to undertake any such project is left with state or local voters and their public officials. Decentralized decision making permits the financing of projects that are necesary to meet local or regional needs through a financing mechanism that is best suited for that particular issuer.

Market participants are particularly troubled that recent federal actions demonstrate to an increasing degree that the federal government views itself as the best arbiter to determine whether a particular financing mechanism is suited for a particular local issuer. Escalating federal intrusions into this market will only have the effect of making federal policy rather than state or local determinations the basis for the types of projects for which municipal securities may be issued. We are fearful that such a result will limit the ability of states and localities to raise funding for infrastructure and public works in an efficient and cost effective manner. Indeed, the logical extension of these federal policies would be the demise of our federalist system of government.

There are two fundamental types of tax-exempt securities—general obligation and revenue securities. General obligation securities are generally backed by the full faith and credit of the state or local government issuing the bonds. In some instances, the issuer's taxing authority is restricted by state constitution or statute. These bonds are called limited tax bonds.

Revenue bonds are paid off from revenues generated by the particular project being financed. The beneficiaries of the project—the customers or users—pay the debt from revenue, not the community as a whole. Also, generally included in the revenue bond category are special tax bonds secured by a specific source of general revenue, such as sales or other excise taxes.

INVESTORS IN MUNICIPAL SECURITIES

Since the mid-1950s, three categories of investors have dominated the municipal securities market. Of the $450 billion of municipal debt outstanding at the end of 1982, we estimate that individuals held approximately 40.6 percent, or $183 billion. Commercial banks held $154 billion, or 34.2 percent, and property and casualty insurance companies held $87 billion, or 19.3 percent.

The relative importance of each of the three major investors has shifted over the years. Individuals have only recently become the largest holders of municipals. This development in in large measure a result of inflation induced tax bracket creep and the development of open-end bond funds and unit investment trusts.

Through much of the 1960s, commercial banks absorbed two-thirds of all new municipal issues. In the 1970s they took on less than one-third. The recently amended corporate minimum tax provision is expected to limit their future purchases to an even larger extent.

Traditionally, casualty insurance companies took up much of the slack. However, in the last two years casualty insurers have played a smaller role in the market primarily because of a cyclical uptrend in underwriting losses which has lessened their need for tax-exempt income.

The individual investor has traditionally been regarded as the "residual" element, or backstop, in the demand equation of municipal securities. Their activity in the market fluctuates widely, with the greatest volume of purchases normally occurring when municipal rates are near their highest levels. In 1969, to take one extreme example, interest rates were at their cyclical peak and individuals accounted for the purchase of almost 97 percent of net new municipal issues. In 1981 and 1982, municipal rates rose to unusually high levels compared to corporate rates (see Table 3) and individuals were again attracted to the market by high interest rates to absorb more municipal bonds than any other single group of investors (see Table 4).

With reduced demand for municipals by commercial banks and property and casualty insurers, individuals were an important element of the municipal market during 1982. At present, individuals (including bond funds), are purchasing approximately 85 to 90 percent of the new long-term financing of state and local governments. While direct total holdings of municipal securities by the household sector has increased in recent years, a larger number of individuals have participated in the market through unit investment trusts and open-end funds purchasing municipal securities. At the end of 1982, $59.4 billion in these funds were outstanding.

Commercial bank demand for municipals increased steadily throughout the 1960s, peaking in 1971 with a $12.6 billion net increase in bank holdings of tax-exempt securities, accounting for 72 percent of the market in that year. Generally, bank demand for municipals since 1971 has diminished. Current statistics show that municipal securities are a relatively minor portion of the change in assets of commercial banks—6 percent in 1981 as opposed to 22 percent in 1971 (See table 5).

One reason for slackened bank demand is that commercial bank profitability has not been strong in recent years. In addition, leasing operations, through which commercial banks make use of investment tax credits, have become increasingly popular as a means of sheltering income from taxes. This practice is likely to expand as a result of accelerated depreciation changes in the 1981 tax laws.

It is further expected that future bank purchases of municipals will decline severely due to the amendment to the corporate minimum tax. The provision was apparently enacted with little Congressional consideration given to its effect on the municipal market.

Property and casualty insurace companies in the past have been important participants in the long-term revenue bond market. The basic motivation for property and casualty company demand for municipals is the same as for commercial banks—after-tax profitability. Their demand for municipal securities is directly related to underwriting profits (or losses). Insurance company profits are cyclical; therefore their purchases of municipal securities follow these cycles.

Property and casualty company participation in the municipal market peaked in 1978-9. However, property and casualty companies have experienced severe and steadily rising underwriting losses since 1979, and their participation has decreased (see table 6).

CURRENT TRENDS IN MUNICIPAL FINANCE

As mentioned earlier, 1982 was a record year for new issues of municipal securities. A total of $123 billion of new securities was issued. New issues of long-term debt exceeded $78 billion and short-term debt amounted to nearly $45 billion (see Table 1).

Market participants continue to be heartened by the recent general decline in borrowing costs for states and localities. The Bond Buyer Index of twenty long-term general obligation bonds on June 10, 1983 was 9.69 percent, down 271 basis points from a year ago (see Table 7).

While precise investment figures are unavailable, it may be helpful to review major uses of tax-exempt debt in 1982. Over $6 billion was raised last year to finance transportation systems, including roads, bridges, ports, and airports. Approximately $5 billion was invested in water and sewer systems. The market provided educational systems with $6.2 billion of capital. Over $14 billion was raised for low and moderate income housing, while $10.6 billion was devoted to health care. More than $7 billion was raised for electric and gas generating facilities.

During the past few years, the fixed income securities markets have been forced to contend with record budget deficits and high levels of inflation. As a result, interest rates rose and fixed income securities were subject to large degrees of price volatility. As inflation abates interest rates for all fixed income securities—including municipal securities—have declined. However, in large part due to growing federal budget deficits, interest rates have declined somewhat but remain high. In addition, continuous changes in federal tax policy have exacerbated the effect of the abovementioned conditions on the municipal securities market. Nevertheless, the municipal market has managed to raise record amounts of capital for states and localities in an efficient and cost effective manner.

The costs of high interest rates to state and local governments are substantial. By way of example, each additional one percent will cost state and local governments an additional $500 million annually on a volume of $50 billion in long-term financing. If one assumes an average life of the securities of 15 years, this would be a cost of $7.5 billion.

During the 1970s, the Bond Buyer Index (BBI) averaged 6.95 percent. So far this year, the BBI has averaged 9.32 percent. This differential of 237 basis points means an added interest cost of $1.2 billion per year, or $18 billion over the estimated life of the debt, based on above example of long-term financing.

High levels of interest rates since 1979 have increased borrowing costs for all entities, taxable and tax-exempt alike. The tax-exempt/taxable yield ratio narrowed due in large measure to federal tax policies which altered the structure of the market, creating an almost continuous air of uncertainty among its participants. While in 1977 the ratio for long-term securities was approximately 60 percent, by late 1981 and early 1982 the ratio reached record levels of approximately 80 percent.

It has been stated that the huge volume of new issues in the municipal market has served to increase yields. However, the evidence does not appear to prove this hypothesis. Although new issue volume continues at a record pace the ratio actually decreased when interest rates declined in late 1982 and early 1983. The ratio for Aaa securities declined substantially from 76.3 percent in January of 1983 to 71.8 percent in March. Aa-rated bonds experienced an even greater decline going from 77.2 percent to 71.6 percent for the first quarter (see table 3).

The narrowing of the tax-exempt/taxable yield ratio supports the theory that interest rate spreads between taxable and tax-exempt securities narrow and widen as the general level of interest rates increases and decreases respectively. This theory is predicated on the notion that when estimating the effect of the supply of new debt on yields, demand must also be considered. When an increase in the supply of debt is met with a concomitant increase in demand, yields remain unchanged. This has occurred in the municipal market. The huge volume of new issues in 1982 and in the first quarter of 1983 was well received by investors. Investor demand restricted any potential yield increase in the market.

It is therefore imperative that the federal government perservere in lowering budget deficits generally, while continuing to keep down the rate of inflation. To this end, the PSA Board of Directors in March 1981 adopted the following resolution:

"Recent inflationary pressures have forced the markets for fixed-income securities to experience historically high interest rates and unacceptable volatility which have increased significantly the borrowing costs of state and local governments and the U.S. Government and its agencies. The health of these markets is vital to the continued efficient operation of government at all levels of our society.

"We support federal efforts to implement a comprehensive economic plan that would reduce the rate of inflation and control federal spending. We believe that the major components of any such economic plan would consist of a federal budget which will restore the public's confidence in the government's ability to control the growth of federal spending; the adoption of a tax policy which would stimulate savings and investment; the elimination of excessive and unnecessary federal regulation; and implementation of a federal program that would reduce the Treasury's use of the public credit markets and establish a disciplined monetary policy. We believe this type of program will serve to improve investor confidence and the efficiency of the public credit markets."

Today we reaffirm that resolution and urge that Congress reduce federal spending further and with it the size of the federal deficit.

Such a change in federal fiscal policy would do more to lower state and local government borrowing costs than any other federal action.

THE CONCEPT OF TAX EXPENDITURE

In recent years federal tax policy has increasingly affected the municipal securities market. It is believed by some that the tax-exemption for state and local government securities is a tax expenditure which can be lessened or eliminated by Congressional action. Consequently, as federal budget deficits have grown, proponents of this view have sought to decrease federal expenditures by limiting the issuance of municipal securities.

However, PSA believes that the concept of tax expenditure should not be applied to municipal securities. The term tax expenditure is defined in the Congressional Budget Act of 1974 as "revenue losses attributable to provisions of the federal tax laws which allow a special exclusion, exemption, or deduction from gross income."

However, we do not share the view that the tax exemption for state and local obligations is derived from an exclusion appearing in the federal tax laws. Therefore, the concept of "federal revenue loss," in our opinion, is not applicable to any discussion of the municipal market.

PSA believes that the basis of the tax exemption for municipal securities lies at the very foundation of our federalist system of government. We believe the tax-exempt status of municipal securities should be preserved to enable state and local governments to continue to perform their responsibilities at the lowest possible cost within this federal system.

Nevertheless, federal tax policy has affected the municipal market. The Social Security Amendments of 1983 contain a provision that would have the effect of taxing interest on state and local government obligations. In addition to unfairly taxing the interest income of retirees the provision would impose the first tax ever on municipal securities. Section 121 of the Act, effective January 1, 1984, mandates the inclusion of tax-exempt interest in calculating the income threshold for taxation of social security benefits.

There is little agreement concerning the impact of the tax on the municipal market at present. However, market participants are greatly concerned that the precedent of this legislation may encourage further taxation of interest earned on municipal obligations.

The Tax Equity and Fiscal and Responsibility Act of 1982 (TEFRA) contained two provisions which artificially stimulated new issue activity during the last quarter of 1982. Aproximately 25 percent of long-term municipal securities in 1982 were issued in November and December. The rapid increase in volume was a leading cause for the increased municipal tax-exempt/taxable yield ratio during that time (see Table 3).

TEFRA established a corporate minimum tax which indirectly taxes bank holdings of municipal securities acquired after 1982. As expected, the provision has limited bank purchases of municipals this year while artificially stimulating bank purchases during the latter part of 1982.

An even larger factor affecting the increase in volume during the latter months of 1982 was the requirement that municipal securities issued after 1982 be in registered form. Although the effective date was delayed late in December 1982, the anticipated registration requirement added significantly to the 1982 volume.

REGARDING CONSIDERATION OF H.R. 1176 AND H.R. 1635

Prior to discussing either H.R. 1176 or H.R. 1635 PSA wishes to make clear its policy that both legislative proposals should be considered separately. It is our view that legislation to continue the mortgage revenue bond programs of states and localities should not be considered in a quid pro quo debate concerning further curtailment of industrial development bonds. Both H.R. 1176 and H.R. 1635 must be considered on their own merits.

In addition, while we are quite concerned with the size of the deficit, we believe that the most prudent approach to our present economic situation is adherence to a comprehensive economic development plan whose primary focus should be reducing the rate of growth of federal spending, stable monetary growth, stimulating savings and investment, and elimination of unnecessary and burdensome federal regulation.

H.R. 1176: THE HOUSING FINANCE OPPORTUNITY ACT

PSA supports strongly adoption of the Housing Finance Opportunity Act (H.R. 1176), a bill that will eliminate the sunset provision for mortgage revenue bonds. Identical legislation has also been introduced in the Senate (S. 137) and is receiving significant and broad bi-partisan support.

We wish to point out at the outset that without enactment of this legislation, the authority of state and local governments to issue tax-exempt bonds to finance single family mortgages for low and moderate income Americans will expire on December 31, 1983. This legislation would simply permit state and local governments to continue to finance their own housing finance programs.

First, and most importantly, we urge the Congress to expeditiously and independently address the issues relating to the continued use of tax-exempt mortgage revenue bonds. This legislation should be reveiwed on its own merits, and judged only in terms of whether it has satisfied the original intent and purposes of the Congress when it adopted the Mortgage Subsidy Bond Tax Act of 1980 and the amendments thereto adopted as part of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).

Moreover, PSA believes that the Congress should adopt this legislation promptly, in order to avoid any unnecessary surge in volume which would occur as a natural consequence of the December 31, 1983, deadline. It is logical to assume that the present uncertainty surrounding the future ability of state and local governments to make use of this valuable form of housing finance is having an unsettling effect on the market and is causing many issuers to alter their timetables to finance issues while they still qualify for tax-exemption.

In 1980, when the Mortgage Subsidy Bond Tax Act was enacted, it was the intention of Congress to target the use of tax-exempt financing for housing. Consequently, tax-exempt mortgage financing was, among other restrictions, limited to first-time homeowners, home purchase price limitations were instituted to assure that the bonds were used for low and moderate income housing, and a distressed area criterion was designed to facilitate neighborhood renewal. Congress further limited the use of mortgage revenue bonds in 1982 by the adoption of TEFRA. The four most significant amendments in TEFRA affecting the use of mortgage revenue bonds included a provision that 80 percent of lendable proceeds be made available to first-time home purchasers, an increase in the purchase price limitation to 110 percent (120 percent in a targeted area) of the average area home purchase price, an adjustment in the arbitrage limitations, and an amendment to the reserve liquidation requirements.

After completing the original process of targeting the use of this financing vehicle in 1980, and adjusting it again in 1982, we believe it advisable to afford this legislation an opportunity to work in an unencumbered and stable environment. This will permit all participants in the tax-exempt housing market, as well as Congress, to adequately evaluate the effectiveness of the existing legislation.

The use of tax-exempt obligations to construct low and moderate income housing has permitted state and local governments to minimize the cost of financing homeownership. This result concurs with the finding of the President's Commission on Housing that affordability of housing is the chief difficuty facing low income renters. Further, the reflow generated by these programs has been beneficial to local economies and tax revenues of all levels of government. Increased construction has resulted in new employment opportunities and increased activity by suppliers of the construction industry. This increased economic activity on the state and local level has resulted in tax revenues on all levels of government which otherwise would not have been generated on the state and local level.

The Council of State Housing Agencies estimates that every $1 billion in mortgage revenue bonds will result in financing for about 9,250 newly constructed single family homes, plus a comparable number of existing homes. They further estimate that this new construction generates almost 12,000 jobs and nearly $100 million in tax revenues, including about $85 million in federal tax revenues. In 1982, it is estimated that 80,000 jobs were created as a by-product of mortgage bond financing.

It is also worth noting that, as interest rates fall along the entire maturity spectrum and conditions in the housing market improve generally, mortgage revenue bonds, because of their built-in criteria, will tend to provide greater benefits and assistance to familes on the lower levels of the income scale. These are the type of familes who would otherwise not be able to afford homeownership.

PSA urges Congress to adopt H.R. 1176 promptly in order that state and local governments will be able to continue to provide needed housing opportunities for our country's low and moderate income homebuying public. Further, we reiterate our position that Congress should independently evaluate the benefits of mortgage revenue bonds separate from and review of other tax legislation.

H.R. 1635; THE INDUSTRIAL DEVELOPMENT BOND LIMITATION ACT

H.R. 1635 would impose significant new restrictions on tax-exempt industrial development bond, both small issue (Section 103(b)(6)) and exempt facility (Section 103(b)(4)), as well as, mortgage revenue bonds.

The legislation would require that depreciable property financed with all forms of IDBs be depreciated on a straight-line basis over extended recovery periods. Low and moderate income rental housing projects would be exempt from this requirement.

Users of small issue IDBs would face two additional restrictions: (1) their total capital expenditures during the 3 years prior to issuance must be less than $20 million and (2) they may have no more than $20 million of shall issue IDBs outstanding after issuance of the bonds. In addition, small issue IDBs may no longer be used to acquire land. The aforementioned restrictions would become effective upon enactment.

Notably, another section of H.R. 1635 would become effective retroactively on April 15, 1983. This section would prohibit tax-exempt IDB financing where obligations are directly or indirectly guaranteed or insured by FDIC or FSLIC insurance.

RETROACTIVE FEDERAL LEGISLATION

Without commenting on the efficacy of the FSLIC provisions, and before addressing the likely impact of H.R. 1635, we wish to state our Association's opposition to the introduction of federal legislation with a retroactive effective date.

In recent years, the introduction of federal legislation affecting the municipal securities market with a retroactive effective date has become more common. This practice has a severely unsettling effect on the market because it creates uncertainty for both state and local governments and investors. The result is to increase the costs of all transactions which may be affected by such legislation and to divert attention away from the public policy issues involved in the legislation. Even more fundamentally, PSA believes that retroactive dating of legislation represents an extraordinary application of the legislative process which should only be undertaken in connection with areas clearly requiring immediate legislative action on the part of Congress. In matters involving public finance, retroactive dating of legislative proposals may effectively accomplish, without Congressional consideration, or majority vote, the objectives which were sought by the legislation's sponsors merely through introduction. The introduction of such proposed legislation usually destroys the ability of state and local governments to carry on the financing programs which such legislation would affect, and therefore has serious disruptive effects on the municipal market.

H.R. 1635

Before noting PSA's specific comments on H.R. 1635 it may be most helpful to begin our discussion by presenting our policy position on small issue IDBs.

The Public Securities Association supports the right of state and local governments to issue tax-exempt securities for public purposes in accordance with state law. However, PSA believes that small issue industrial revenue bonds have had an adverse effect on the municipal securities market, and urges that state and local governments take positive steps to curtail their use.

Our Association opposes federal legislation which would restrict the right of state and local governments to determine the public purposes for which bonds can be issued. We believe that any federal action concerning small issue IRBs should be limited only to the tax treatment of direct, private beneficiaries of the proceeds of small issue IRBs.

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) added a number of restrictions concerning industrial development bonds. Small-issue IDBs are scheduled to sunset after 1986. Generally, property financed with IDBs must be depreciated over ACRS recovery periods on a straight-line basis. TEFRA introduced requirements concerning public hearings, elected official approval, and new reporting requirements. The legislation also prohibited types of specific IDB financings.

It is submitted that broad legislation concerning IDBs should not be approved by the Congress until it is first able to analyze the effects of the recently enacted restrictions contained in the Tax Equity and Fiscal Responsibility Act. In particular, limitations on the use of IDBs, further changes in the depreciation rules concerning the bonds, and the new requirements regarding the financial status of firms that use projects financed by IDBs should await further analysis. Enactment of the restrictions contained in H.R. 1635 would only serve to increase uncertainty of market participants regarding the ultimate purpose of Congressional legislation in this area.

In addition, we object to any legislation that would limit "exempt facility" and charitable purpose bonds. We believe that any proposal applied to these bonds represents a form of restriction which compromises the rights of state and local government to issue tax-exempt securities for traditional public purposes.

The 1968 federal legislation creating IDBs contained such a broad definition of "industrial development bond" that any significant private involvement in a project could result in IDB status. Congress recognized, however, that these projects are financed in the municipal market because they involve facilities for public use and benefit or extensions of publicly used facilities. Consequently, Congress decided that tax-exempt financing of those projects was necessary and appropriate and should not be restricted in order to permit state and local governments to fulfill the general needs of the public. Special categories were therefore established to continue this financing for traditional public purpose projects, including airports, port facilities, mass commuting and parking facilities, sports or convention facilities, housing projects, water, electric, sewage and waste disposal facilities as well as for certain charitable and non-profit organizations.[2]

Today, municipal financing for such projects is essential for the construction or redevelopment of infrastructure and facilities necessary for the social and economic well being of all citizens. The fact that private parties may operate or otherwise benefit from these facilities simply reflects the historic practice of state and local governments in providing public works necessary to support and maintain residential communities and commercial and industrial development.

We also wish to note that, at this time PSA has no position concerning the provision in H.R. 1635 that would prohibit IDB financing where obligations are directly or indirectly guaranteed or insured by FDIC or FSLIC deposit insurance.

CONCLUSION

PSA believes that the municipal securities market has provided states and localities with an efficient and cost-effective mechanism for financing projects deemed by states and local governments to be of public benefit. The market has again demonstrated its strength and vitality by financing a record volume of new issues while at the same time lowering the cost of borrowing both absolutely and relative to other types of debt instruments. More importantly, the municipal market provides states and localities with a much needed source of capital to meet their needs independent of the federal government. We believe that this independence should not be sacrificed to the ever growing demands of federal budget deficits. Increased tampering with this market by the federal government will only reduce its effectiveness and undermine the confidence of investors.

In closing we would like to reiterate our view that mortgage revenue bond programs of states and localities have proven their benefit to society and should not be terminated. Further, we urge Congress to investigate the effect of TEFRA of industrial development bonds prior to enacting yet additional restrictions on these securities.

TABLE 1.—NEW ISSUES OF MUNICIPAL SECURITIES BY MONTH—1982

[Amounts in billions]

Month	Long term	Short term	Total
January	$3.9	$2.6	$6.5
February	3.7	2.8	6.5
March	5.7	3.1	8.8
April	6.7	3.2	9.9
May	5.7	6.1	11.8

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[2] In the 1968 statute Congress also authorized tax-exempt financing for pollution control facilities owned by private corporations. Although there is a public benefit associated with a cleaner environment, the proceeds of tax-exempt pollution control bond issues generally benefit a single corporate polluter. This exemption was added by Congress to the 1968 legislation to assist corporations in meeting federal pollution standards. PSA has a policy position in support of eliminating the use of tax-exempt municipal securities to finance pollution control facilities which are owned and operated by local governments. PSA believes that the federal government should adopt other ways of assisting private industry in its efforts to meet federal environmental standards.

TABLE 1.—NEW ISSUES OF MUNICIPAL SECURITIES BY MONTH—1982—Continued

[Amounts in billions]

Month	Long term	Short term	Total
June	5.8	4.9	10.7
July	5.6	3.4	9.0
August	6.5	4.8	11.3
September	6.7	3.2	9.9
October	8.4	3.4	11.8
November	10.1	4.1	14.2
December	9.4	3.1	12.5
January to December 1982	78.3	44.7	123.0
January to December 1981	47.8	37.4	85.3
Dollar change	30.5	7.3	37.7
Percent change	63.8	19.4	44.3

Source: Public Securities Association, Municipal Securities Data Base.

TABLE 2.—NEW ISSUES OF MUNICIPAL SECURITIES BY MONTH—1983

[Amounts in billions]

Month	Long term	Short term	Total
January	$3.6	$3.1	6.7
February	5.9	1.9	7.8
March	7.9	2.2	10.1
January to March 1983	17.5	7.2	24.7
January to March 1982	13.3	8.5	21.8
Dollar change	4.2	(1.3)	2.9
Percent change	31.6	(15.2)	13.3

Source: Public Securities Association, Municipal Securities Data Base.

TABLE 3.—TAX EXEMPT/TAXABLE YIELD RATIO

	Short term	Long-term			
		Aaa	Aa	A	Baa
1981:					
January	40.2	70.1	68.0	68.7	65.9
February	38.9	70.9	70.1	69.2	66.0
March	43.4	71.3	70.5	69.7	67.8
April	44.3	70.5	70.8	71.1	69.7
May	40.0	69.0	69.5	70.2	70.5
June	43.0	71.7	71.5	71.4	70.9
July	44.9	71.0	71.9	71.9	71.4
August	46.2	74.5	77.7	78.6	78.2
September	59.4	74.6	79.0	81.0	80.4
October	59.9	78.2	79.0	78.0	78.0
November	53.7	77.2	74.9	76.2	77.4
December	54.9	82.2	74.4	80.0	80.4
1981 annual average	47.4	73.4	73.1	73.8	73.1
1982:					
January	52.6	81.0	81.5	83.3	81.6
February	49.9	79.9	80.7	80.7	80.5
March	54.3	81.9	80.3	83.1	81.5
April	53.7	80.6	81.1	79.9	79.2
May	54.6	77.5	77.2	76.6	75.4
June	55.0	78.0	78.3	77.0	75.3
July	56.2	78.5	79.9	78.0	78.4

TABLE 3.—TAX EXEMPT/TAXABLE YIELD RATIO—Continued

	Short term	Long-term			
		Aaa	Aa	A	Baa
August	55.7	77.9	75.3	72.4	75.7
September	46.8	74.9	75.4	70.5	76.0
October	48.1	75.5	73.3	68.9	72.4
November	48.8	80.9	77.8	73.5	75.5
December	56.2	78.9	79.2	74.9	76.4
1982 annual average	52.7	78.8	78.3	76.6	77.3
1983:					
January	53.2	76.3	77.2	73.0	78.8
February	46.1	73.3	72.4	70.9	75.9
March	51.7	71.8	71.6	70.2	73.8

Sources: Short term: Federal Reserve Bulletin, Bank of America Quote Sheet, Weekly Money Market Summary of Continental Illinois National Bank and Trust Co. Long term: Moody's Bond Survey.

TABLE 4.—PARTICIPATION IN THE MUNICIPAL MARKET BY INDIVIDUALS (EXCLUDES MUTUAL FUNDS)

[Dollar amounts in billions]

Year	Net change in municipals	Dollars	Household sector as percent of net new municipals	Purchases as percent of change in financial assets
1982	60.7	47.6	78.4	15.2
1981	35.0	18.5	53.0	5.3
1980	25.0	3.3	13.2	1.2
1979	18.0	−[1] 2.4		
1978	28.3	3.3	11.7	1.3
1977	23.7	2.6	11.0	1.1
1976	15.7	2.5	15.9	1.3
1975	16.1	6.2	38.5	3.9
1974	16.5	8.3	50.3	6.3
1973	14.7	5.3	36.1	3.5
1972	14.7	2.3	15.6	1.8
1971	17.4	.1	.6	.01

[1] Individuals were net sellers of municipal securities.

Source: Federal Reserve Board of Governors, Flow of Funds.

TABLE 5.—SELECTED MEASURES OF COMMERCIAL BANK DEMAND

[Dollar amounts in billions]

Year	Net change in municipals	Dollars	Changes in commercial bank holdings	
			As percent of net new municipals	As percent of change in bank assets
1982	60.7	0		
1981	35.0	8.2	23	6
1980	25.0	13.6	54	13
1979	18.9	9.5	50	7
1978	28.3	9.6	34	7
1977	23.7	9.2	39	9
1976	15.7	3.0	19	5
1975	16.1	1.8	11	6
1974	16.5	5.4	33	8
1973	14.7	5.7	39	7
1972	14.7	7.2	49	9
1971	17.4	12.6	72	22

Source: Board of Governors of the Federal Reserve System, Flow of Funds Accounts.

TABLE 6.—PROPERTY AND CASUALTY INSURANCE CO. PARTICIPATION IN THE MUNICIPAL MARKET

[Dollar amounts in billions]

Year	Net change in municipals	Changes in casualty company holdings		
		Dollars	As percent of net new municipals	As percent of changes in financial assets
1982	60.7	2.2	4	16.7
1981	35.0	1.0	3	6.0
1980	25.0	8.4	34	41.0
1979	18.9	12.3	65	61.0
1978	28.3	13.1	46	67.0
1977	23.7	10.7	45	53.0
1976	15.7	5.4	34	36.0
1975	16.1	2.6	16	36.0
1974	16.5	2.2	13	47.0
1973	14.7	3.6	24	56.0
1972	14.7	4.3	29	54.0
1971	17.4	3.5	20	53.0

Source: Board of Governors, Flow of Funds.

TABLE 7.—THE BOND BUYER INDICES JUNE 1982–JUNE 1983

[Average municipal bond yields]

Date	20 general obligation bonds	25 revenue bonds
1983:		
June 9	9.69	10.26
June 2	9.78	10.25
May 26	9.51	9.96
May 19	9.29	9.77
May 12	8.86	9.28
May 5	8.78	9.21
Apr. 28	8.82	9.26
Apr. 21	9.09	9.38
Apr. 14	9.04	9.37
Apr. 7	9.23	9.58
Mar. 30	9.38	9.73
Mar. 24	9.15	9.73
Mar. 17	9.19	9.85
Mar. 10	9.22	9.95
Mar. 3	9.04	9.62
Feb. 24	9.34	9.91
Feb. 17	9.53	10.08
Feb. 10	9.72	10.23
Feb. 3	9.74	10.30
Jan. 27	9.66	10.33

TABLE 7.—THE BOND BUYER INDICES JUNE 1982–JUNE 1983—Continued

[Average municipal bond yields]

Date	20 general obligation bonds	25 revenue bonds
Jan. 20	9.48	10.15
Jan. 13	9.37	10.10
Jan. 6	9.48	10.37
1982:		
Dec. 30	9.56	10.54
Dec. 22	9.84	10.66
Dec. 16	10.05	10.81
Dec. 9	10.13	10.79
Dec. 2	10.23	10.92
Nov. 24	10.16	10.85
Nov. 18	10.20	10.79
Nov. 10	9.92	10.67
Nov. 4	9.96	10.66
Oct. 28	10.05	10.82
Oct. 21	9.69	10.47
Oct. 14	9.25	9.78
Oct. 7	9.75	10.31
Sept. 30	10.48	10.98
Sept. 23	10.58	11.10
Sept. 16	10.74	11.47
Sept. 9	10.75	11.64
Sept. 2	10.74	11.97
Aug. 26	10.38	11.85
Aug. 19	10.82	12.28
Aug. 12	11.86	12.84
Aug. 5	11.87	12.90
July 29	11.97	13.05
July 22	12.01	13.12
July 15	12.36	13.32
July 8	12.47	13.36
July 1	12.58	13.58
June 24	12.62	13.58
June 17	12.63	13.51
June 10	12.40	13.15

Mr. PICKLE. Mr. Phillips?

STATEMENT OF GEORGE C. PHILLIPS, JR., EXECUTIVE DIRECTOR, ILLINOIS HEALTH FACILITIES AUTHORITY AND PRESIDENT, COUNCIL OF HOSPITAL FINANCE AUTHORITIES

Mr. PHILLIPS. Thank you, Mr. Chairman.

I represent the Council of Hospital Finance Authorities, an association of 21 State authorities each of which issues securities on behalf of nonprofit health care facilities. The health facilities served by our member authorities are organizations exempt from tax under section 501(c)(3) of the Internal Revenue Code of 1954, which include many of the Nation's university and church-sponsored hospitals.

The council is concerned by pending proposals which would impose restrictions on tax-exempt bonds issued for 501(c)(3) health care facilities. The council opposes these proposals for the reasons set forth in detail in my prepared statement which I am submitting for the record. The following is a summary of our views.

We believe the principal concerns of this committee and of pending proposals such as H.R. 1635 are with the use of tax-exempt financing for private purposes. We believe tax-exempt financing for charitable institutions serves largely public purposes and, therefore, raises questions quite distinct from those raised by proposals to restrict the use of tax-exempt financing for private purposes.

The council believes that any new restrictions on tax-exempt financing will adversely affect the Nation's health care delivery system. Tax-exempt financing has played a substantial role in the supply of capital to the Nation's nonprofit hospitals. The use by nonprofit hospitals of tax-exempt financing has been necessitated by restrictions on other sources of capital, restrictions which, in many cases, are the products of or were exacerbated by Federal Government policies.

The ultimate result in restricting tax-exempt financing of charitable hospitals in the current environment will be the erosion of the capital base and physical plant of nonprofit health care institutions. At the time same, we doubt that there would be any significant revenue gain from restricting tax-exempt financing by nonprofit hospitals.

The loss from the tax exemption of such financing is offset by revenue gains or expenditure reductions which the tax exemption generates. We believe the existing estimates do not properly take into account those offsetting factors which are discussed in detail in my prepared statement. When these offsetting factors are taken into account, we believe there is serious doubt that there is any real revenue loss from the exemption of interest on hospital revenue bonds.

Tax-exempt financing is necessary to place tax-exempt hospitals on a par with taxable entities. Taxable entities benefit from a large number of incentives to capital investment which do not benefit tax-exempt entities.

We believe that estimates of the revenue effect of tax-exempt hospital financing are overstated. We believe that the existing estimates do not take into account a number of important factors, including most importantly that the increased cost of taxable hospital borrowings would increase the amount of medicare and medicaid reimbursement paid by the Government, and that the restriction of the exemption would reduce revenues resulting from reflow effects of hospital investment.

When these and other factors are taken into account, we believe it has never been substantiated that there is any real revenue loss from the exemption of the interest on hospital revenue bonds.

The council in general opposes the specific proposals before the committee today concerning industrial revenue bonds embodied in H.R. 1635. As indicated in my full statement, many of the authorities represented by the council issue industrial development bonds for facilities which are owned by exempt organizations but are occupied primarily by nonexempt persons; namely, physicians.

We believe the use of tax-exempt financing for these facilities contributes to the health care delivery systems of the States we represent. Accordingly, we oppose the enactment of H.R. 1635 and would suggest if the committee is inclined to accept that proposal that an exception be made for health care facilities' financing of industrial development bonds.

We will be pleased to respond to any questions the committee may have.

[The prepared statement follows:]

STATEMENT OF GEORGE C. PHILLIPS, JR., EXECUTIVE DIRECTOR, ILLINOIS HEALTH FACILITIES AUTHORITY, ON BEHALF OF THE COUNCIL OF HOSPITAL FINANCE AUTHORITIES

Thank you, Mr. Chairman. I am grateful for the opportunity to be here this morning, and to share with the Committee the views of the Council of Hospital Finance Authorities concerning H.R. 1176 and H.R. 1635, and other recent proposals concerning tax exempt financing.

The Council of Hospital Finance Authorities (CHFA) is a not-for-profit corporation whose membership comprises twenty-one state authorities, each created under the laws of its respective state. The principal function of each of the Council's member authorities is to administer and monitor the issuance of revenue bonds for nonprofit health care facilities in its respective state. The health care facilities which benefit from the financing are for the most part organizations exempt from Federal income tax under section 501(c)(3) of the Internal Revenue Code.

I am Executive Director of the Illinois Health Facilities Authority, one of the members of the Council, and am also the current President of the Council.

CHFA is, in general, opposed to the imposition of new restrictions on tax exempt financing, particularly tax exempt financing by hospitals and health care facilities. We believe that the availability of such financing plays a vital role in enabling the states whose authorities we represent to ensure the availability of a high quality health care delivery system to their citizens.

We believe that proposals to restrict such financing, including proposals like that embodied in H.R. 1635, Congressman Pickle's bill, would impede the efforts of our members to maintain the quality of health care services in their respective states.

We believe this Committee's concern at the present time is principally with the use of tax exempt bond financing for so-called private purposes. However serious may be the bases of those concerns, it is clear that institutions exempt from Federal income tax under section 501(c)(3) present questions distinct from those presented by industrial development bonds and other more purely "private" uses of tax exempt financing. Tax exemption for charitable institutions is predicated, in part, on the recognition that such groups provide services which otherwise would become the obligation of government to furnish. Such is clearly the situation respecting charitable nonprofit hospitals. If these institutions did not exist, the medical care and services they provide would be a direct burden upon government. Thus, the availability of tax exempt financing for such groups comports with the underlying rationale that the exemption be utilized in support of public purposes.

We believe it is important for the Committee to understand, in approaching the general question of tax exempt financing for health care facilities, the dimensions of the capital needs of hospitals and other health care facilities, and the role which tax exempt financing plays in meeting those needs.

It is true that there has been substantial growth in recent years in the use of tax exempt financing by private nonprofit hospitals. But that growth must be understood in light of the erosion of alternative sources of financing for nonprofit hospitals.

The first tax exempt offering issued in connection with a hospital capital project was issued by Connecticut in 1966. In 1968, the majority of the capital requirements of tax exempt hospitals were still satisfied by conventional sources of hospital equity financing—namely, government contributions, both Federal and state; private contributions; and internally generated funds—which at that time supplied roughly 60.5 percent of the capital of charitable hospitals. Only about 39.5 percent of the capital requirements of these hospitals was supplied by debt finance, and almost all the debt issued by these hospitals was taxable debt.

A substantial market for tax exempt hospital revenue bonds was first developed during the late 1960s and early 1970s. By the early 1980's, however, a substantial majority of nonprofit hospital capital requirements (about 70 percent) were met by debt financing, and the great preponderance of this (about 55 percent of total capital requirements) were satisfied by tax exempt borrowings. Since the mid-1970s, the proportion of new hospital capital which has been derived from debt financing has remained in the 60–70 percent range.

Tax exempt financing now constitutes roughly 80 percent of all debt financing by nonprofit hospitals, and thus supplies over half of all new capital raised by those hospitals. The distribution of sources of capital for the nation's section 501(c)(3) hospitals has been projected to remain along these orders of magnitude throughout the 1980s.

The increasing resort by tax exempt hospitals to debt financing has been stimulated by a number of conditions in the hospital industry which will continue throughout the 1980's to lead hospitals to resort to debt in financing their capital projects in roughly the same proportion as in the immediate past. Perhaps the most significant of these is the method of accounting for a return on capital used in determining Medicare and Medicaid reimbursement payments. Under existing regulations, interest is counted as an allowable cost in computing Medicare and Medicaid reimbursements, which are computed upon a cost of service basis, but no amount is allowed as a return on equity to nonprofit entities, although a return on equity is counted as an allowable cost in reimbursing investor-owned hospitals.

Obviously, tax exempt financing plays a significant role in meeting the capital needs of the nation's charitable hospitals. Such hospitals play a dominant role in the nation's overall health care delivery system. This makes clear that serious questions of health policy are raised by proposals which would restrict the use of tax exempt hospital revenue bonds.

The most important grounds for opposing new restrictions on hospital revenue bonds is that such restrictions will adversely affect the ability of the nation's charitable hospitals to continue to deliver high quality health care service. Restrictions on tax exempt financing by hospitals will inevitably lead to the undercapitalization of such hospitals, and to the erosion of the financial structure, capital base, and physical plant of the hospitals, and ultimately of the quality of the delivery system.

This is because, as the figures cited above suggest, sources of capital other than tax exempt financing have been greatly eroded by a number of developments in recent years. Many of these developments have been created or aggravated by policies of the Federal Government.

Government financing is clearly no longer a viable source of equity financing for private section 501(c)(3) hospitals. In the late 1960's and early 1970's, the Federal Government shifted its focus with regard to a number of welfare activities, including health, education and housing, from subsidy for the construction of physical plant to direct subsidy to the user of the services. Educational construction assistance was replaced in part by student loan and student assistance; housing assistance was to some extent supplanted by rent subsidies; hospital construction assistance was supplanted by the Medicare and Medicaid program. Although the dollar volume of financing by the state and local governments increased slightly during the period, it fell far short of compensating for the falloff in Federal assistance. But neither Federal nor state and local assistance to hospital construction can be expected to increase in any substantial amount in the immediate future, nor would we or the hospital industry necessarily welcome a return to programs of direct Government subsidy to hospital capital projects.

The amount of financing derived from private contributions can be expected to continue to decline as inflationary and recessionary conditions impinge upon the ability and desire of prospective donors to dedicate substantial portions of their wealth or income to charitable purposes. In addition, the rate reductions in the corporate and personal income taxes enacted in 1981 substantially increase the after tax cost to prospective donors of such contributions.

Earnings accumulation is not a promising source of financing. Federal and state reimbursement payments do not fully cover the cost of service; only about 85 percent of costs are reimbursed under Medicare, and 70 percent under Medicaid. These percentages will decline further in consequence of recently enacted reductions in reimbursement payments.

Taxable debt does not provide a promising alternative to tax exempt financing. At one extreme, the private placement taxable market offers only a very limited prospect for financing nonprofit hospitals. The private placement market is characterized by a small number of very selective investors who invest in only the strongest hospitals. This market is unlikely to be an expanding source of capital for tax exempt hospitals generally. At the other extreme is the publicly traded securities market. But virtually no independent institution, certain no nonprofit institution, is able to compete effectively with other issuers in this market, primarily because the average hospital bond issue is very small compared to the average corporate securities issue ($12.2 million for an average hospital revenue bond in 1980, compared to $50 to $70 million regularly reported as the size of debt issues by corporate borrowers). It is also very difficult to develop an active secondary market in taxable hospital bonds after their initial distribution; no such market now exists.

Accordingly, there is virtually no alternative source of financing which will be able to meet the capital needs of the nation's charitable hospitals without an increase in the capital costs to the hospitals greatly disproportionate to whatever cost, if any, the Treasury incurs on account of the exemption of the interest from tax. Consequently, the result of limiting the availability of tax exempt financing to charitable hospitals will be a gradual erosion in the capital base of those institutions. This will result both in the underutilization of health care resources other than physical plant, and a deterioration of health care services provided to the public.

In addition, in many respects the tax exemption does no more than place charitable hospital borrowers on rough after-tax parity with taxable private borrowers.

It must be remembered, in the context of investment by tax exempt hospitals, that such hospitals do not benefit from the variety of tax based incentives to capital investment which are enjoyed by taxable investors, including investor-owned hospitals. When taxable entities finance the construction of a facility, including the construction or improvement of a hospital, they may claim an investment tax credit equal to 10 percent of the depreciable personality acquired or constructed with the proceeds of a borrowing, and they also enjoy substantial tax benefits from the accelerated cost recovery system enacted under the 1981 Economic Recovery Tax Act, even as modified by the Tax Equity and Fiscal Responsibility Tax Act of 1982.

These benefits are not enjoyed by tax exempt hospitals, since they pay no tax. But these benefits enable a taxable borrower, with whom tax exempt hospitals must compete for available capital, to pay a higher rate of interest on any borrowing it undertakes. In an environment where capital financing by taxable borrowers is stimulated by investment tax credits and accelerated cost recovery allowances, restricting the exemption on the interest on borrowings by section 501(c)(3) organizations would be discriminatory against such organizations.

Indeed, provisions enacted by TEFRA with respect to tax exempt financing, as well as many of the specific proposals for further restrictions, including those embodied in H.R. 1635, reflect a recognition that the accelerated cost recovery system and tax exempt financing constitute alternative means of encouraging capital investment. The 1982 provisions limit the application of the ACRS provisions to property financed by tax exempt borrowing; and H.R. 1635 and some other recent proposals would limit that application stillfurther. The predicate of these measures is that when a borrower enjoys the benefit of both, he is enjoying a "double-dipping" of tax benefits.

In this context, too, I believe it is important to address assertions, suggested by the Congressional Budget Office among others, that tax exempt financing leads to the construction of unnecessary hospital capacity. The Council of State Hospital Finance Authorities strongly believes that such suggestions are without foundation.

In the first place, it must be remembered that there are substantial government and market place controls on hospital construction. Under section 1122 of the Social Security Act, depreciation and interest expense associated with capital expenditures are not reimbursed unless certain necessary planning approvals are obtained. Accordingly, hospitals will not undertake a financing in the absence of a certificate of need issued by the appropriate state board.

Perhaps more important, the market itself exerts controls on the construction of unnecessary projects, since investors will scrutinize any proposed project to determine that the need for the project in the territory the project is designed to serve is such that there will be a reasonable expectation that the project will generate sufficient revenues to service the debt.

This effect will be enhanced when reimbursement revisions enacted in 1982 take effect. Those revisions will permit additional earnings accumulations by the more efficient hospitals. This will in turn affect the credit standing of the hospitals, enabling the more efficient hospitals to borrow at lower rates.

A causal relationship between the issuance of tax exempt hospital bonds and the level of aggregate hospital construction has never been demonstrated. The record shows that tax exempt financing has been used principally to refinance existing debt, usually to reduce the cost of servicing outstanding debt, and to renovate existing facilities or to convert them to new uses, rather than for new construction.

Since the early 1970's, when tax exempt financing first became generally available to hospitals, and first came to be used to a significant extent, the number of acute care beds per thousand population has not increased substantially. Moreover, there has been a negative correlation between the issuance of bonds and the amount of construction, including renovation, replacement, and facility conversion. From

1974 to 1979, the dollar volume of tax-exempt hospital bond issues increased 670 percent; but hospital construction starts declined by 40 percent, and construction completed by 36 percent. From 1974 to 1979, between 25 and 46 percent of the volume of tax exempt bonds issued were for refinancing existing debt at lower interest rates.

In summary, we believe there exists no basis for suggestions that tax exempt financing leads to excess hospital capacity. Such financing has been used to fill the legitimate capital needs of a major segment of the nation's hospital industry. Those legitimate needs can be expected to grow over the immediate future, at a time when alternatives to tax exempt financing have been eroded and remain highly unreliable.

At the same time that hospital revenue bonds play a substantial role in enabling charitable hospitals to maintain their capital base, the Council of State Hospital Finance Authorities believes that it has never been demonstrated that restricting the use of these bonds, when all primary and secondary consequences of their issuance are taken into account, would result in any gain in Federal revenues.

The Congressional Budget Office has estimated that revenue savings from eliminating these bonds would amount to about $100 million in the first year following the imposition of new restrictions, rising to about $600 million annually within five years. We believe those estimates are substantially overstated for at least four significant reasons:

First, the estimates do not account for the reductions which such financings generate in Federal, state, and local assistance and insurance program reimbursement payments. Tax exempt hospital financing reduces Federal, state and local health care reimbursement payments, so the savings to beneficiary hospitals are passed back to third party cost payors in the form of lower reimbursements for interest expense. The Federal Government receives direct benefits through reduced Medicare and Medicaid reimbursement payments, and this effect will be enhanced if Medicaid is completely federalized, as the President has proposed. In 1980, we believe the reduction in Medicare and Medicaid reimbursement payments offset at least 27 percent of whatever revenue losses the tax exemption entails for the Treasury. Another 6 percent were offset by reduced state and local government reimbursement payments under Medicaid, and other assistance and insurance programs.

Second, the estimates do not account for increased revenues resulting from the economic activities stimulated by hospital investment in modernization and improvement as well as the expansion of needed hospital capacity. As I indicated above, tax exemption for revenue bonds operates in many respects to stimulate investment activity in the same way expedited capital allowances or investment credits operate. The secondary effect of such tax expenditures is an increase in economic activity, which in turn generates a partially offsetting increase in revenue.

Third, the estimates overstate the amount of revenue loss caused by the displacement of taxable issues. Many issues of tax exempt debt would not be replaced by taxable debt issues. A substantial number of investors in the tax exempt market would shift investment from tax exempt securities not into taxable securities, but into real estate or other assets the increment in the value of which is not currently taxable.

Fourth, the estimates do not account for the rate reductions effected by the 1981 Tax Act. The across-the-board 25 percent rate reduction, and, more important, the reduction of the top maximum rate from 70 to 50 percent, tend to reduce the after tax value of tax exempt bond issues, and to increase the tax exempt interest rate. The income tax rate reductions thus result in less tax loss as a result of exempt bonds, since displaced taxable investments would have been taxed at a lower rate relative to the tax exempt rate.

When all of these circumstances are taken into account and added together, I believe it is possible that their combined effect wipes out the revenue loss estimated by the CBO. Therefore, we believe this Committee and the Congress as a whole should be skeptical of any claim that there will be any measureable revenue gain from proposals to limit the use of hospital revenue bonds.

The Council of Hospital Finance Authorities opposes any new restrictions on tax exempt bonds as unproductive in budget terms, and potentially destructive in terms of health care policy. These considerations are pertinent to any proposal to restrict or eliminate tax exempt financing for hospital revenue bonds.

In closing, I would like to make a few specific observations about H.R. 1635, introduced by Congressman Pickle. H.R. 1635 addresses issues specifically with respect to industrial revenue bonds, and would not affect tax exempt financing by nonprofit health care facilities. Accordingly, the bill would not affect the main area of concern of my organization.

Many of our member organizations, however, have jurisdiction over the issuance of industrial revenue bonds to the extent those bonds are used to finance facilities related to the health care delivery system in their respective states. Some of our authorities, including my own, issue industrial revenue bonds on behalf of Section 501(c)(3) hospitals; others issue them for the construction of, for instance, medical complex office buildings which are occupied primarily by nonexempt persons, such as physicians.

From this standpoint, our organization is concerned in general with proposals to limit industrial revenue bonds. H.R. 1635 would impose additional limitations on the cost recovery deductions claimable by person where facilities are constructed with tax exempt financing, and would impose limitations on small issue industrial development bonds, to the extent the principal user of the bonds is a large business, as defined in the bill. Our organization questions whether such additional restrictions are necessary, in light of the restrictions already adopted in the Tax Equity and Fiscal Responsibility Act of 1982, and believes that they would if enacted impair the use of these bonds to finance facilities which do vitally affect the health care delivery in our respective states.

For these reasons, the Council is in general opposed to H.R. 1653. We believe that the Congress should allow the states to continue to use revenue bonds even for taxable borrowers, if the proceeds of those bonds is to finance facilities related to the health care delivery system in their respective states. We believe that even if the Committee is disposed to enact new restrictions on revenue bonds in this area, it should give serious consideration to excepting from the restrictions on the use of the accelerated cost recovery system bonds used to finance health care facilities, like the exceptions included under TEFRA for residential rental property, solid waste disposal facilities, air and water pollution control facilities connected to existing facilities, and facilities subject to urban development action grants.

For the reasons I have set forth, the Council of Hospital Finance Authorities believes that the availability of tax exempt financing for section 501(c)(3) health care facilities under federal law should be continued. We believe that restrictions imposed on this financing would have an untoward effect on the health care system of the nation, in terms of the erosion of the capital base of the nation's hospitals, and would, in terms of national tax policy, result at best in raising an insignificant amount of revenue.

I welcome the opportunity to answer any questions you may have.

Mr. PICKLE. Thank you, Mr. Phillips.

Let me make this observation: As I have looked at your testimony—and it has been looked over by the staff—you spent nine pages making statements in dire opposition to the bill that has been proposed. And then on the ninth page, you said, "Accordingly, the bill would not affect the main area of concern of my organization." You set up all the dummies for nine pages about how terrible it would be, but yet you conclude on your own that it doesn't affect your main concern.

Then you go on to say that what your real concern is is that it might stop the construction of mediplexes for the nonexempt groups, for physicians.

Is that an unfair statement that I have made to you?

Mr. PHILLIPS. Let me put it in context for you, Mr. Chairman.

Mr. PICKLE. All right.

Mr. PHILLIPS. In this sense, industrial development bond financing as opposed to revenue bond financing represents a smaller amount of financing for hospital facilities than does the former. And what I am saying is for those institutions that have to utilize it, it is extremely important. But in terms of the total volume of financing, it is not as great, and I wanted to put that in perspective for the committee.

Mr. PICKLE. But you don't object to our bill. You just spent eight pages saying how bad it was, and then you say it really doesn't affect the nonprofit hospital system that you are concerned with.

What I am really concerned about, you say, is that it might prevent you from construction of the medical complex office buildings which are occupied primarily by nonexempt persons such as physicians.

I have to say to you that you are hollering wolf out there, and I can't help but make that observation. It may be a relatively small part of the overall cost, but the fact is you are saying that basically the bill doesn't affect what you are trying to protect, except what you are interested in is construction of medical complexes for physicians.

I say to you that is not a straightforward position to make. If you want to respond, I would be glad to do it.

Mr. PHILLIPS. Mr. Chairman, I think that in terms of those institutions that require the use of medical office buildings in provision of that care, and they cannot obtain those moneys through a straight tax-exempt revenue bond, it is extremely important to them. I am thinking in terms that if they had to borrow those moneys in a taxable fashion, it would ultimately reflect itself in higher reimbursement rates for medicare patients.

Mr. PICKLE. I just say to you, Mr. Phillips, that we ought to remind ourselves of the purpose of the bill and what we are trying to do in making these limitations. The bill that I have introduced would help tax-exempt hospitals, and it would help them by limiting the volume of other private purpose bonds, and thus reduce the interest rates for health care financing by nonprofit hospitals. That is what it really does.

And you come in and want to protest that we cut out some of these, I suppose, lucrative projects you are trying to finance. I think what you are trying to do, I have to assume—there is nothing illegal about it—you are just trying to protect the doctors. You want to build more facilities for them.

Mr. PHILLIPS. Not at all, sir. Every project that is financed through any of the State authorities requires going through a certificate of need process to determine whether the project is needed. They are not built for the benefit of the physicians but rather for the benefit of the public that requires the care from the institutions that are doing the borrowing.

Mr. PICKLE. Mr. Phillips, I want to say again to you that the bill we have introduced—you have obviously read it—does not affect nonprofit hospitals, and you know it. I think you are trying to spook us all in some other areas. I am just making that observation.

Mr. Arnspiger, let me talk to you next now. You represent the bond holders, investment houses.

Mr. ARNSPIGER. Yes, sir.

Mr. PICKLE. You are interested in selling all the revenue bonds you can. The Government pays for it and the people pay for it. That is your business, and obviously a good business, and thank goodness we have the tax-exempt program or our cities and counties couldn't finance their business. We can't protest about that.

You acknowledge that the proliferation of these small issue bonds is a problem, but you would look to the States primarily, or local governments, to control the issuance of these bonds.

Mr. ARNSPIGER. That is correct.

Mr. **Pickle**. What is the incentive for a State or local government to limit issuance of these bonds?

Mr. **Arnspiger**. Don't you think we should start off with what is the incentive to issue to begin with? States and local government do not issue just for the fun of issuing, but are trying to accomplish a public purpose.

Mr. **Pickle**. They are trying to accomplish a public purpose.

Mr. **Arnspiger**. That is right.

Mr. **Pickle**. You say there should be no limit to them at all?

Mr. **Arnspiger**. No. I think what I said, Congressman, is that the control should be at the State and local level, and not at the Federal Government level. It should be their determination.

Mr. **Pickle**. Then you would say that based on the Constitution, you quote the Constitution.

Mr. **Arnspiger**. Yes, sir. I do.

Mr. **Pickle**. We ought not to try to make any controls over that. Well, we created the IDB, the Congress did.

Mr. **Arnspiger**. Yes. You created what, sir?

Mr. **Pickle**. The industrial development bond program, IDB program.

Mr. **Arnspiger**. You did? I thought it was done in Mississippi, sir.

Mr. **Pickle**. Sir?

Mr. **Arnspiger**. I thought the first issue of IDB was in the State of Mississippi in the 1930's.

Mr. **Pickle**. The Congress officially approved a IDB program and we have allowed the States and localities to participate in these bonds. Now, as I recall it, we helped grant the tax-exempt status on issues of that program. If we don't have a way to control——

Mr. **Arnspiger**. Did you say you granted tax-exempt status?

Mr. **Pickle**. We allowed deduction of these bonds as tax exempt, whether for water, sewer, school projects.

Mr. **Arnspiger**. I thought there was reciprocal tax immunities between Federal and State governments.

Mr. **Pickle**. Of course, there is. We don't argue that point at all.

Mr. **Arnspiger**. All right.

Mr. **Pickle**. Here your organization comes up here and trying to say we ought not to interfere at all with the local government on issuance of these bonds.

Mr. **Arnspiger**. That is correct.

Mr. **Pickle**. I am talking about public purpose bonds. We are talking about private issue bonds.

Mr. **Arnspiger**. Sir, would you mind defining "public purpose" for me?

Mr. **Pickle**. Well, I will let you define it.

Mr. **Arnspiger**. We have wrestled with it for about—I have been in this business for 30 years and for the last 10, we have been wrestling with the definition of public purpose. I think the problem is this: We have a diversity of cities, counties, and States, all with different economic bases, and all with different public purposes to serve. And to try at this level of government—the Federal level—to tell every State in the United States what their public purpose is is ridiculous, it is ludicrous. I don't think I could do it. I don't think you can do it.

Mr. **Pickle**. I think we have to try to distinguish between the public and private purpose moneys. You can argue that anything is public or private if you want to go around in a circle about it.

Mr. **Arnspiger**. Absolutely.

Mr. **Pickle**. But you and I know——

Mr. **Arnspiger**. It depends on whose ox is in the ditch——

Mr. **Pickle**. Or whose bonds you want to sell.

Mr. **Arnspiger**. Absolutely.

Mr. **Pickle**. That is the purpose of the whole thing.

I notice in your testimony, Mr. Arnspiger, you don't make reference to the fact that we do away with the FSLIC and FDIC guarantee that will be curtailed in this bill.

Mr. **Arnspiger**. That is correct.

Mr. **Pickle**. You make no comment about that.

Mr. **Arnspiger**. I did make a comment about it.

Mr. **Pickle**. I just didn't see it then. Sorry.

Mr. **Arnspiger**. I said our industry has not determined a position with respect to that.

Mr. **Pickle**. You mentioned it but you didn't take a position. Why didn't you take a position?

Mr. **Arnspiger**. Do you want me to give you my personal position? I am not here to testify as chairman of Westcap. I am here for the Public Securities Association. The Public Securities Association Board has not taken a position on that.

Mr. **Pickle**. Do you think the Congress should eliminate that FSLIC and FDIC procedure that has been going on?

Mr. **Arnspiger**. Are you suggesting I give you my own position or the association's position?

Mr. **Pickle**. Give me both.

Mr. **Arnspiger**. I have done that. As an industry, we have no position.

Mr. **Pickle**. All right.

Mr. **Arnspiger**. Not as yet. As an individual, I can argue either side of it. You tell me how you want me to argue.

Mr. **Pickle**. Well, I would say this to you, I am not trying to argue this thing to you, but I think most people, authorities, Members of Congress, think this is a bad program, bad tax policy to allow a group of investors promoted by bond attorneys and investment bankers to put up $100,000 in the program and have the full faith and credit of the U.S. Government up to that amount. How can a local rural school or county issue bonds when they don't have that protection?

You would break the Federal Government if we don't put a stop to it and the Federal Government has come in here, the Treasury and the rest of them, saying we ought to do away with this. We have had nobody yet come in and say that that ought to be continued.

You know that is wrong. Yet, you come up here fiercely taking no position on it. You take no position and it seems to me, sir, that that is irresponsible for you to do either as an individual or a national official.

Mr. **Arnspiger**. Congressman Pickle, frankly, you sound like you are repeating my statement at our last board meeting. I tried to urge our board into taking a position. They were not prepared to do it at that time. So, individually, I would be happy to discuss my feelings about it, very happy to And I apologize that PSA has not yet taken a position. All I can say is that at this time, we have no position on FDIC/FSLIC bonds. But if you want to talk economics—dollars, reflow—I can argue either side of the case for you. I really can.

Frankly, one other thing I would like to say is that our industry is getting slugged about the head and shoulders about how we are ripping off the United States. I saw an article in the Washington Post this morning about where all the money for these programs is going to—the dealers. There has been some insinuation that we are here to formulate tax exemptions for our purpose. Frankly, Congressman, I deal in bonds. I don't care whether they are taxable, tax-free, or otherwise, I will still deal in bonds. But you should care whether they are tax-free or not because you are a Representative of the people in your district who will have to pay higher taxes if we don't have tax-free bonds. It's as simple as that.

The Treasury can turn it any way they want, but if it is tax-free, it is cheaper, which means that every person in the United States pays lower taxes or, lower user fees.

That is the simplest thing in the world. I am not an economist. I am a boy from Texas. Pure and simple.

I know this, if I borrow money, I have to pay it back. If I borrow money at 15 percent, it will cost me more than it would at 10 percent. I believe Treasury has been looking at the wrong end of the funnel for years.

Mr. PICKLE. Thank you.

Mr. ARNSPIGER. Thank you.

Mr. PICKLE. Mr. Rangel.

Mr. RANGEL. No questions.

Mr. PICKLE. Mr. Duncan.

Mr. DUNCAN. You have about covered everything I can think of. Does your group build hospitals and in turn lease them to for-profits companies?

Mr. PHILLIPS. No, sir. All we do is issue bonds, but the sale/lease-back provisions I think you refer to, no, we have not been involved in them.

Mr. DUNCAN. Thank you very much.

Chairman ROSTENKOWSKI. If there are no further questions, thank you very much, gentlemen.

[The following was subsequently submitted by Mr. Phillips:]

HOSPITAL
Financial Management
Journal of the Hospital Fi[illegible] [illegible]nagement Association April 1982

Followi[illegible] the equip[illegible]ent acquisitio[illegible] process

Volume 36/Number 4

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- Surviving a debt rating
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Congressional threat?

Tax-exempt hospital bonds: key questions and answers

by George C. Phillips Jr.

THIS YEAR Congress will consider various proposals to restrict tax-exempt revenue bond financing. Some of the restrictions under consideration would substantially reduce the availability of tax-exempt financing to private, not-for-profit hospitals. Although efforts to restrict the issuance of tax-exempt bonds have been made in the past, the threat to tax-exempt hospitals has never been so direct.

While it may be appropriate to restrict the availability of tax-exempt financing to some users, there is no justification for any substantial reduction in healthcare facilities' access to the tax-exempt market. Indeed, none of the policy concerns advanced against tax-exempt hospital financing supports any change in current law as it applies to tax-exempt hospitals:

- Health policy considerations weigh strongly in favor of retaining the availability of tax-exempt hospital financing. Significant amounts of hospital capital are needed for facility renovation, replacement, conversion and expansion projects. Most of this capital must be raised by issuing debt because of the substantial impairment by the Federal government of tax-exempt hospitals' other sources of capital. As to the concern that tax-exempt hospital financing leads to excessive hospital expansion, this contention has never been demonstrated and all the evidence shows that this has not occurred.
- The budget policy concern of reducing Treasury revenue losses, presently a major impetus behind efforts to restrict tax-exempt financing, is less applicable to hospital bonds than to any other use of tax-exempt financing. This is primarily because of offsetting reductions in Medicare and Medicaid reimbursement payments for interest expense. For this and other reasons, tax-exempt hospital financing is far less expensive than generally estimated.
- The tax policy issues of whether a public purpose is served by the project financed, reductions in tax rate "progressivity," and the "uncontrollability" of tax expenditures have little force when applied to hospitals. Tax-exempt hospitals serve the unquestionably public purpose of maintaining the health of the community, the same essential public purpose served by public institutions. Any reduction in the progressivity of the tax rate structure is amply justified by this public purpose. In addition, effective governmental controls on hospital capital projects and on the issuance of bonds to finance these projects are already provided by state and local health planning agencies, rate-setting bodies, and bond issuing authorities. Indeed, because tax-exempt hospital financing is administered by a decentralized system of state and local governmental decisionmakers, this form of financial assistance is a particularly appropriate role for the Federal government in the Federal system.
- The credit policy concerns of capital allocation distortions and increased municipal bond interest rates also have little force in the case of hospitals. The extensive Federal involvement in healthcare financing has an overwhelming effect on the allocation of capital to hospitals, and the volume of tax-exempt hospital bonds is too small a fraction of the bond market to affect municipal bond rates significantly.

None of the policies supporting the restriction of tax-exempt financing would be advanced as much as the healthcare system would be damaged by any substantial decrease in the availability of this essential form of hospital financing.

Recent restrictions on substantially different tax-exempt bond users

Congress has restricted the availability of tax-exempt financing twice in the past two years.[*] In 1980, Congress acted to severely restrict the issuance of mortgage subsidy bonds for single family

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residences and to terminate their use on Dec. 31, 1983.[b] In 1981, Congress focused its attention on certain users of small-issue industrial development bonds (IDBs). Hearings were held on perceived abuses of IDB financing, such as the financing of recreational establishments and retail stores, and a report was issued recommending certain restrictions on their use.[c] However, there are substantial factual and policy differences that distinguish hospital bonds from these other types of tax-exempt financing considered by Congress. These other uses were not in furtherance of an essential public purpose such as maintaining the health of the community, were not performed by tax-exempt charitable institutions, and were not subject to any effective form of governmental control.

Proposals under consideration

The Reagan Administration, in its FY 1983 budget, has proposed restricting tax-exempt revenue bond financing. Some of the restrictions under consideration as this article is written would virtually terminate the availability of tax-exempt financing to private, not-for-profit hospitals. One such proposal would require that financially hard-pressed units of state or local government make additional financial contributions to tax-exempt hospital construction projects, beyond the substantial commitments already made to these institutions in the form of tax abatements. Such additional contribution requirements are not likely to be met in many cases. Another proposal would require that in addition to the approvals of health planning agencies, rate-setting bodies, and bond issuing authorities, an elected official or body also approve the project. This proposal and others would needlessly delay construction and increase project costs.

Questions and answers

The operation of tax-exempt hospital financing and the consequences of substantially restricting its use requires an examination of complex and interrelated questions of health, budget, tax and credit policy. These questions must be answered in the context of the present state of the nation's tax-exempt hospitals and the other elements of the healthcare system, including: the demand for hospital capital; the expected changes in other Federal policies affecting the availability and cost of capital for hospitals; and other unique circumstances of hospital financing.

The balance of this article is a discussion of these questions.

Health policy

Q. In this period of budgetary restraint, what special circumstances exist to justify this Federal benefit?

Continued on page 44

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[a] See generally, G. Gayer, *The Case For Hospital Tax-Exempt Bonds*, *Hospital Financial Management* June 1981, A. Fine and H. Pell, *Will Hospital Financing Survive Congressional Scrutiny*, *Hospital Financial Management*, June 1981, at 56.

[b] Omnibus Reconciliation Act of 1980, PL 96-499, Title IX. Also in 1980, the Carter Administration proposed to restrict the issuance of tax-exempt hospital bonds by requiring Federal health planning approval of each project seeking such financing; this proposal was withdrawn by the Reagan Administration and was not considered by Congress. 45 Fed. Reg. 41,096-99 (June 17, 1980).

[c] Oversight Committee's Report and Recommendations Relating to Small Issue Industrial Revenue Bonds, May 14, 1981. In a related action, Congress acted to prevent the IRS from expending any funds to enforce a revenue ruling (81-216) which effectively would prohibit state governments from issuing umbrella or pooled bond issues. However, this compromise amendment to the Continuing Resolution funding the Federal government until March 31, 1982, also provided that enforcement would be prohibited only in the case of IDBs backed by the state or local government, used by firms which had less than $25 million of capital expenditures in a three-year period, and where the proceeds were not used for various recreational purposes. The adoption of these limits was an ominous precedent for future Congressional action on IDBs and perhaps other revenue bonds as well.

Tax-exempt revenue bonds: Questions and answers

From page 43

Tax-exempt financing for private, tax-exempt hospitals is justified by the purposes for which this financing is used and by the impairment of these institutions' traditional sources of capital by actions of the Federal government.

Estimates of the amount of capital which will be needed by hospitals in the 1980's range from $130 to $190 billion—more than double the amount of hospital investment in the 1970's.[d] This capital is needed to renovate old, inefficient facilities, to replace obsolete equipment (especially in teaching and research hospitals), and to comply with various licensing requirements. It is also needed to convert existing facilities to new uses in response to changed modes of patient care. The introduction of more competition into the healthcare system is expected to increase the amount of capital required for many of these purposes. Where medically underserved areas exist, caused by population shifts and an aging population, capital is needed for expansion.

Tax-exempt financing for tax-exempt, private, not-for-profit hospitals is especially justified by the charitable nature of these institutions. Historically, these hospitals have improved the health of their communities by providing medical services to those in need, regardless of their ability to pay.

Tax-exempt hospital financing is also justified because the traditional sources of capital for private, tax-exempt hospitals—earnings accumulation, charitable contributions and debt issuance—have been impaired by a variety of Federal government actions:

- Earnings accumulation has been reduced, and in some cases entirely eliminated, by Federal and state reimbursement payments which do not fully cover the costs of service. Only about 85 percent of costs are reimbursed under Medicare and 70 percent under Medicaid.[e] These percentages will be reduced further by recently enacted reductions in Federal reimbursement payments,[f] and future additional reductions are expected. Earnings accumulation has also been reduced because of increasing amounts of charitable services and bad debts in a recessionary economy.
- Charitable contributions to tax-exempt hospitals are expected to decline as a result of the personal and corporate income tax rate reductions enacted by the 1981 Tax Act.[g]
- These reductions in earnings accumulation and charitable contributions will necessitate the increased use of debt to finance capital projects. The proportion of construction expenditures funded by debt issuance has been projected to increase from 75 percent in 1977 to more than 90 percent in 1983.[h] Credit-worthiness will decrease as debt-to-equity ratios increase and Federal reimbursement payments are reduced. These factors will make it increasingly difficult for hospitals to receive investment-grade bond ratings. Under such circumstances, entry into the 30-year long-term bond market becomes much more difficult, often necessitating the use of short-term borrowing. Such borrowing can result in a continual need to roll over increasing amounts of short-term debt, with the ultimate effect of eroding the financial structure of the institution to the point where long-term debt is completely unavailable.
- Current and foreseeable high interest rates make borrowing even at tax-free rates very costly. Much borrowing by hospitals in 1981 occurred despite high interest rates because of the inability of some institutions to delay construction further, because of the rapid escalation in construction costs coupled with the requirement that the project be completed within cost targets mandated by the health planning agency, and because of fears that Congress might restrict tax-exempt hospital borrowing.

  Borrowing at taxable rates would be extremely difficult for many nonprofit hospitals in today's market. The shorter maturity of taxable issues would result in insufficient cash flows because reimbursements for depreciation would be less than required payment of principal. Moreover, the additional cost of taxable issues would not be fully offset by increased interest expense reimbursements.
- Hospitals must compete for funds in credit markets. The borrowing needs of the Federal government, $41 billion in the first quarter of 1982 alone, as well as the large credit needs

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d. J. Valiente, *The Dimensions of Capital Requirements*, presentation to the National Health Lawyers Association, Jan. 20, 1982; M. Hernandez, S. Valimahomed, *The Capital Formation Environment of the 1980s*, Hospital Corporate Planning, A Report of the 1980 National Forum on Hospital and Health Affairs.

e. *Case for Bonds; see also*, P. Pine, M. Gornick, J. Lubitz, M. Newton, *Analysis of Services Received Under Medicare by Specialty of Physician*, Health Care Financing Review, September 1981. (In 1977, Medicare paid an average of 19.5 percent less than average submitted charges); L. Lewin, R. Derzon, R. Margulies, *Investor-Owneds and Nonprofits Differ in Economic Performance. Hospitals*, July 1, 1981, (nonprofit hospitals price their services to Medicare and Medicaid patients at or below cost).

f. Omnibus Budget Reconciliation Act of 1981, PL 97-35.

g. See C. Clotfelter, L. Salamon, *The Federal Government and the Nonprofit Sector: The Impact of the 1981 Tax Act on Individual Charitable Giving* (a study for the Independent Sector) The Urban Institute, August 1981.

h. *Evaluation of Future Hospital Capitalization*, a study commissioned by Standard & Poor's Corporation and prepared by Booz, Allen & Hamilton (hereinafter "Booz, Allen"), Oct. 16, 1978.

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of utilities and municipalities, are likely to keep rates from falling substantially for some time.

- This competition for credit has been increased by the Federal government's recent increases in the supply of tax-exempt investments. The new "All Savers Certificates" and the expansion of the exemption for Individual Retirement Accounts are prime examples.
- The corporate and personal tax rate reductions of the 1981 Tax Act have increased tax-exempt interest rates by reducing the spread between taxable and tax-exempt rates from the 30 to 35 percent range to the 15 to 20 percent range.

Q. Would tax-exempt hospital financing continue to be justified if proposals to create a more competitive healthcare environment are implemented?

A. This form of hospital financing would not only continue to be justified, but would be necessary. Vigorous competition among healthcare providers will be hindered if tax-exempt hospitals, an essential part of the nation's healthcare system, suffer substantial, perhaps irreparable, erosion of their financial structure, capital base and physical plant. In addition, recent actions of the Federal government have already biased this competition against tax-exempt hospitals by enhancing the ability of investor-owned institutions to accumulate capital, while hindering the capital accumulation of tax-exempt institutions. For example:

- The Accelerated Cost Recovery System and the corporate tax rate reductions of the 1981 Tax Act assist investor-owned institutions in accumulating capital; tax-exempt hospitals received no such benefit.
- Because tax-exempt hospitals serve proportionately more patients whose care is financed

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Hospital bonding authority: The Illinois experience

The Illinois Health Facilities Authority was created by the Illinois General Assembly in 1972. It is one of 25 state authorities designed to assist not-for-profit hospitals, nursing homes, and other healthcare facilities provide quality medical care at the lowest cost via tax-exempt capital financing.

The authority is governed by a seven-member board serving seven-year terms appointed by the governor and confirmed by the state senate. The operating staff of the authority consists of five persons supported by external legal and financial advisors.

The purpose of the authority is realized through the sale of tax-exempt notes and bonds, the proceeds of which are loaned to qualified healthcare institutions to finance maintenance and expansion of their physical resources and in some instances to refinance existing indebtedness.

As of Jan. 1, 1982, the Illinois Health Facilities Authority had financed 123 issues representing $1,730,859,605 since its inception. The credit supporting these issues is that of the borrowing institution and does not constitute a debt of the state of Illinois other than the limited obligation of the authority. Until 1976, the authority retained title to the borrowing institution with a lease back to the institution until the bonds or notes were retired. Since that time, recognizing the restrictiveness of this methodology, the authority implemented "pass through" mortgages as security for the bonds and notes. This has become a standard for the industry.

The authority initiated specific equipment financing in the form of a $1,260,405 lease revenue note issued for Rush-Presbyterian-St. Luke's Medical Center in early 1977. In late 1977, this financing program was modified to a standardized "pass through" mortgage financing with the equipment as security and using standardized legal documents to minimize expenses of the transaction. Between November 1977 and October 1981, the authority issued $2,225,000 under this program. Then, in response to volatile market conditions and, in particular, the short-term market, as of November 1981, the authority implemented its "pooled equipment" financing program in the form of a $49,385,000 issue.

As the largest single issuer of healthcare bonds and notes in the nation, the authority continually strives to improve its services. In the past year, language was developed to permit "affiliate leases" for restructured corporations permitting diversification of the contemporary healthcare institution. Implementation of a "springing mortgage," which takes effect upon reaching a specified debt service coverage level, is another feature which gives the borrowing institution greater flexibility so long as its financial health remains intact.

Since the authority derives its revenues for operation from fees assessed the borrowing institutions, it strives to minimize the expenses of operation, while at the same time, being an innovative issuer. Over the course of the last two years, the authority has returned on a pro rata basis, fees of $250,000 to all of the healthcare institutions that have financed through the authority. Hopefully, this is reflected as a genuine effort to reduce the cost of health care.

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by Medicare and Medicaid than do investor-owned institutions,[i] they will suffer more severe revenue decreases as the result of reimbursement reductions. This disparity is expected to increase as investor-owned hospitals become reluctant to serve Medicare and Medicaid patients at reduced reimbursement levels, and these patients are shifted to tax-exempt hospitals.

- Tax-exempt borrowing helps to put the borrowing cost of tax-exempt hospitals on a basis comparable to the after-tax borrowing cost of investor-owned hospitals. Tax-exempt hospitals cannot take full advantage of tax incentives, such as the deduction of interest and depreciation expenses and investment tax credits, which benefit taxable institutions. Tax-exempt borrowing by tax-exempt institutions is an equalizer between tax-exempt and investor-owned institutions, not an advantage. The denial of tax-exempt financing to tax-exempt hospitals would amount to another action in favor of investor-owned institutions at the expense of tax-exempt institutions.
- Certain Medicare policies amount to additional disparate treatment directly affecting capital accumulation: Medicare reimburses investor-owned hospitals, but not tax-exempt hospitals, for return on equity, and does not reimburse tax-exempt hospitals for the costs of seeking charitable gifts.

Q. Are there effective controls on hospital construction and the issuance of tax-exempt hospital bonds?

A. Yes. There are effective governmental and marketplace controls on its use. Under Section 1122 of the Social Security Act, depreciation and interest expenses associated with a capital expenditure are not reimbursed unless the necessary planning approvals are obtained.[j] Because denial of such reimbursement in the case of any significant capital expenditure would seriously jeopardize repayment of the debt, a certificate of need or similar approval is a practical precondition to any tax-exempt financing.

In addition, bond issuing authorities can effectively deny tax-exempt financing to projects that are not economically sound or not in the interest of the people of the state. Most important, because the hospital is ultimately responsible for repayment of the debt issued, investors demand that the proposed project is necessary; otherwise the revenue necessary for debt repayment will not be forthcoming.

Q. Has tax-exempt financing led to the construction of unneeded hospital capacity?

A. A causal relationship between the issuance of tax-exempt hospital bonds and the amount of hospital construction has never been demonstrated. Rather, the facts show that tax-exempt financing has been used primarily to refinance existing debt, usually at lower costs, and to renovate existing facilities or convert them to new uses, such as ambulatory care centers which reduce the number of beds and reduce healthcare costs.

- Since the early 1970's, when tax-exempt financing became generally available to hospitals, and tax-exempt hospital bonds were issued in significant amounts, the number of acute care beds per thousand population has not increased substantially (from more than 4.2 in 1972 to less than 4.5 in 1979). In addition, the rate of growth in this statistic has not increased at all since at least 1960.[k]
- Since 1972, there has been a strong negative correlation between the issuance of tax-exempt hospital bonds and the amount of hospital construction, including renovation, replacement and facility conversion. From 1972 to 1979, the volume of tax-exempt hospital bond issues has increased 670 percent, and the volume used for construction has increased 660 percent[l] while hospital construction starts declined by 40 percent[m] and hospital construction completed declined by 36 percent[n] (all figures are in constant dollars).
- Of 113 institutions completing tax-exempt financing through 15 state health facilities financing authorities (of 20 authorities active nationwide) in 1978 and 1979, 24 increased bed capacity, while seven reduced capacity and 82 left capacity unchanged.[o]
- From 1974 to 1979, between 25 and 46 percent of the volume of tax-exempt hospital bonds issued were for refinancing at lower interest rates.[p] Such refinancing lowers the costs of health care by reducing interest expenses.

Q. Is tax-exempt financing an efficient way of assisting hospital investments?

[redacted] Yes. The efficiency (the ratio of hospital savings to Treasury revenue losses) of tax-exempt hospital financing has been substantially understated by the Treasury and the Congressional Budget Office (CBO). It is likely to be higher than the efficiency of the alternative,

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[i] L. Lewin, R. Derzon, R. Marguiles, *Investor-Owneds and Nonprofits Differ in Economic Performance. Hospitals*, July 1, 1981.

[j] See 42 U.S.C. §1320 a-1.

[k] Booz, Allen, p. 4.

[l] Congressional Budget Office, *Tax Subsidies for Medical Care: Current Policies and Possible Alternatives* (hereinafter "Tax Subsidies"), January 1980.

[m] American Hospital Association, *Report on Tax-Exempt Hospital Financing* (hereinafter "AHA Report").

[n] Bureau of the Census.

[o] *AHA Report* p. 9.

[p] See *Tax Subsidies*, p. 49.

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direct Federal subsidy programs, for the following reasons:

- Actual Treasury revenue losses are much less than generally estimated, and may even be less than hospital savings.
- Administrative costs in the issuance of tax-exempt financing are less than comparable administrative costs in Federal direct subsidy programs.[q]
- Another important but often overlooked aspect of efficiency is the ratio of the value of the construction project to its cost. Because tax-exempt financing can be arranged much more quickly than a direct subsidy could be approved, construction cost increases caused by delays (generally estimated to be one percent per month), which add nothing to the value of the project, are minimized.
- The principal source of inefficiency identified by the Treasury and the CBO (returns to high-bracket investors in excess of the after-tax returns on their taxable investments) will be substantially decreased by the recent reduction in the top marginal tax rate from 70 to 50 percent.[r]

Q. Is this benefit targeted to those projects where capital is most needed?

A. The benefits of tax-exempt financing are directed to needed projects by a decentralized system of state and local government control, rather than by the Federal government. State health planning agencies, state rate-setting bodies, state bond issuing authorities, and investors effectively direct these benefits to needed projects.

Budget policy

Q. Would the termination of tax-exempt hospital financing result in a significant increase in Treasury revenues?

A. No. The actual revenue loss caused by the issuance of tax-exempt hospital bonds is much less than the $100 million (in FY 1982) estimated by the CBO, for the following reasons:

1. The CBO estimates do not account for offsetting reductions in Federal, state and local assistance and insurance program reimbursement payments.

- Tax-exempt hospital financing reduces Federal, state and local healthcare reimbursement payments because savings to beneficiary hospitals are passed back to third-party cost payors in the form of lower reimbursements for interest expenses. The Federal government receives direct benefits through reduced Medicare and Medicaid reimbursement payments, and will benefit even more if Medicaid is federalized as the President has proposed. State and local governments similarly benefit through reduced reimbursement payments in Medicaid and other assistance programs and by reduced premium payments to private insurers, for whom state governments are sometimes the largest customer.
- The reduction in Federal Medicare and Medicaid reimbursement payments in 1980 offset at least 27 percent of the CBO-estimated Treasury losses.[s]
- Another 6 percent of the CBO-estimated revenue losses were offset by reduced state and local government reimbursement payments un-

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q. Administrative costs of the Hill-Burton program do not provide a fair comparison because they do not include many costs of financing—costs such as those for document preparation, placement fees, and legal fees—and also because the level of monitoring of that program has been criticized as insufficient by the General Accounting Office. See GAO report, *Hospital Loan Assistance Programs: Actions Needed to Reduce Anticipated Defaults*, HRD-79-64, June 27, 1979.

r. This source of inefficiency is the return received by high-bracket investors above that necessary to attract them from taxable investments. The interest rate spread between taxable and tax-exempt bonds, historically 30-35 percent, reflects the benefit to the borrower and the break-even marginal tax rate at which investors are indifferent between holding taxable and tax-exempt bonds. Investors of tax-exempt bonds in brackets above this marginal rate get a higher return than investors in the marginal tax bracket require to clear the market. Although factors other than the top marginal tax rate undoubtedly influence the tax rate to tax-exempt rate spread, that spread has now narrowed to 15 to 20 percent, indicating a major reduction in this source of inefficiency.

s. Offsetting reimbursement savings are the product of interest savings to hospitals and the percent of hospital revenues which are paid by the Federal government. In 1978, the Senate Budget Committee estimated that the interest expense savings of institutions benefitting from tax-exempt financing equalled 75 percent of Treasury revenue losses. On the average, the Federal government paid 37 percent of the revenues of hospitals benefitting from tax-exempt financing in 1980, primarily through Medicare and Medicaid payments. Because these payments include reimbursement for interest expense on a *pro rata* basis, 37 percent of the savings, which were assumed to equal 75 percent of revenue loss, was passed back to the Federal government in the form of reduced payments. See generally, R. Gibson and D. Waldo, *National Health Expenditures, 1980*, Health Care Financing Review September 1981 (hereinafter "National Health Expenditures") (Of the total expenditures for hospital care, the Federal government paid 41 percent and state and local governments paid 13 percent in 1980. Total hospital expenditures equalled $99.6 billion. Subtracting expenditures at institutions which cannot benefit from the use of tax-exempt financing (Veterans Administration, $4.8 billion, DOD, $3.3 billion, Public Health Services, $1.1 billion, and state and local hospitals, $6 billion) leaves $84.4 billion; Federal Medicare ($26.3 billion) and Medicaid ($5.2 billion) are 37 percent of this $84.4 billion.)

t. State and local governments paid 8 percent of hospital revenues through Medicaid and other assistance and insurance program payments. This 8 percent share of the 75 percent savings equals 6 percent of the revenue loss. See id. (Of the $84.4 billion spent on hospitals which can benefit from tax-exempt financing, $6.8 billion (8 percent) was spent by state and local governments: state Medicaid payments ($4.3 billion), state and local workman's compensation ($1.9 billion) and public assistance ($.6 billion). This does not include $6 billion spent on state and local hospitals.)

der Medicaid and other assistance and insurance programs in 1980.[t]

2. The CBO estimates do not account for increased tax revenues resulting from investment-stimulated economic activity.

- All Federal tax and direct expenditures are assumed to increase economic activity and thereby increase tax revenues in the amount of approximately 30 percent of the amount of the expenditures. Expenditures which directly induce productive capital investments, however, have a greater than average economic stimulus.[u] This is especially true where nonproductive speculative investments, which are most often used by high-bracket taxpayers who invest in tax-exempt securities, are displaced by productive investment activities.

3. The CBO estimates overstate the amount of revenue losses caused by displaced taxable issues.

- Many issues of tax-exempt debt would not be replaced by taxable debt issues. Most refinancing (which accounted for between 25 and 46 percent of all tax-exempt hospital bonds from 1974 to 1979)[v] would not be undertaken at taxable rates.
- In addition, many investors in taxable hospital securities, such as pension funds, pay little or no Federal income tax. The replacement of such debt by tax-exempt bonds therefore causes little loss in tax revenues.

4. The CBO estimates do not account for the

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[u] In hearings on small issue IDBs, a University of Chicago economist, Dr. Roger C. Kormendi, disagreed with CBO and Treasury IDB revenue loss estimates and their underlying assumptions. Hearings in the House Committee on Ways and Means, Subcommittee on Oversight, April 8-10, 1981. In the study on which his testimony was based, he and co-author Thomas T. Nagle (also an economics professor at the University of Chicago's Graduate School of Business) had concluded that revenue losses due to IDB sales were only one-sixth the amount estimated by CBO. See also R. Kormendi and T. Nagle, *A Summary of the Nature and Effect of Small-Issue Industrial Development Bonds* (1981); R. Kormendi and T. Nagle, *The Interest Rate and Tax Revenue Effects of Mortgage Revenue Bonds*, July 26, 1979. Other witnesses cited a 1980 study by the economic consulting firm of Norman B. Ture, who is now Treasury Undersecretary for Tax and Economic Affairs, concluding that the economic activity generated by IRBs causes net gains in Federal tax revenues. Norman B. Ture, *Economic and Federal Revenue Effects of Changes in the Small Issue Industrial Development Bond Provisions*.

[v] See *Tax Subsidies* p. 49.

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The Hospital Financial Management Association, formerly the American Association of Hospital Accountants, was formed in 1946 as a not-for-profit educational association. Its more than 20,000 members are directly or indirectly associated with financial management in hospitals and other healthcare institutions in the United States, Canada and several foreign countries. Membership in any of the 75 local chapters brings both local and national educational and other professional benefits. Membership questions should be directed to the Director of Membership and Chapter Services.

George C. Phillips Jr. discusses some of the key questions in "Congressional threat? Tax-exempt hospital bonds." With Congress due to consider various proposals to restrict tax-exempt revenue bond financing, understanding the issues is vitally important to hospital leaders. Phillips is executive director of the Illinois Health Facilities Authority.

A graduate of Ohio State University, Phillips received a M.H.A. from Duke University. Earlier, he was assistant director at Massachusetts General Hospital, Boston, and president of Memorial Medical Center, Springfield, Ill. He also served as a hospital consultant.

Phillips

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tax rate reductions of the Economic Recovery Tax Act of 1981 (the 1981 Tax Act).

- The across-the-board 23 percent rate reductions, and more important, the reduction of the top rate from 70 to 50 percent, will tend to reduce the number of tax-exempt bonds issued by increasing the tax-exempt interest rate. The tax rate reductions will also result in less tax loss per tax-exempt bond issued because any displaced taxable investments would have been taxed at a lower rate.
- The reduction in the top tax rate from 70 to 50 percent will increase the percentages of offsetting interest expense reimbursement savings above the 27 percent Federal and 6 percent state and local offsets which existed in 1980. By decreasing the difference between the tax brackets of the "marginal" bond buyer and buyers in the highest bracket, hospital savings as a percentage of revenue losses, and hence offsetting savings as a percent of revenue loss, will increase.

Tax policy

Q. Does the use of tax-exempt financing reduce the equity and progressivity of the tax system?

A. All tax preferences reduce progressivity. However, this reduction will be lessened by the lowering of the top tax bracket from 70 percent to 50 percent. In addition, any such decrease in tax progressivity is amply justified by the charitable nature of the institutions receiving the benefit of this tax-exemption and by the public purposes served by the investments assisted.

Q. Are tax-exempt hospital bond revenue losses uncontrollable because they do not require Congressional approval each year?

A. It is true that these revenue losses are not subject to the appropriations process, as is the case for all tax expenditures. However, as discussed earlier, there are other effective governmental and marketplace controls on the issuance of hospital bonds.

Credit policy

Q. Does this form of Federal assistance for hospital financing distort the free market's allocation of capital?

A. The extensive Federal involvement in healthcare financing, and thus indirectly in both the supply of and demand for health facilities capital, makes comparisons to capital allocation in a theoretical free market extremely difficult. Tax-exempt hospital financing, however, is less intrusive on the operation of a free market than other forms of Federal involvement in health care.

Q. Does the amount of hospital tax-exempt bonds significantly increase the interest rates, and thus the borrowing costs, for other state and local governmental purposes?

> *By far the most significant effect on state and local governments of the use of tax-exempt hospital bonds is to decrease their expenditures for health care.*

A. There is no evidence that the volume of tax-exempt hospital bonds issued in any area is having a significant effect on municipal bond interest rates. Inflation and Federal fiscal and monetary policies are by far the dominant influences on municipal bond rates. In addition, it is no more appropriate to attribute any increase in municipal bond rates to hospital bonds than to attribute such increases to bonds issued for other purposes because the interests served by hospital bonds are no less public than those served by other municipal bond issues. By far the most significant effect on state and local governments of the use of tax-exempt hospital bonds is to decrease their expenditures for health care. This is especially so in states with urban hospitals.

Q. Has the volume of hospital tax-exempt bond issues increased the cost of borrowing to the Federal government?

A. A comparison of the relative amounts of hospital tax-exempt bonds issued to the level of Treasury and corporate bond issues indicates that the effect of hospital bond issues on Treasury interest rates must be quite small. In 1981, $93 billion of U.S. Treasury were issued, $34 billion of publicly offered corporate bonds (with private issues bringing the corporate total to $47 billion), $45 billion of long-term tax-exempt bonds (with shorter-term tax-exempt financing bringing the tax-exempt total to $80 billion), and $5 billion of tax-exempt hospital bonds.[w] Therefore, tax-exempt hospital bonds accounted for 11 percent of long-term tax-exempt bonds issued and 6 percent

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w. See, e.g., *The Bond Buyer*, Jan. 4, 1982, p. 18.

x. M. Lightle, *Changes in Sources of Capital for Health Care Providers*, presented at National Health Lawyers Association, Jan. 20, 1982.

of all tax-exempt issues, and equalled 5 percent of the volume of Treasury bonds issued and 3 percent of the total public bond market.

Conclusion

The problem of attracting affordable capital is expected to be the critical issue facing hospitals in the 1980's. Approximately $150 billion will be needed by hospitals in the 1980's for renovation, replacement of obsolete equipment, conversion of facilities to adapt to a new, more competitive environment, and expansion in response to significant demographic changes.

In 1979, tax-exempt financing was the source of 55 percent of all hospital construction capital.[8] Because of reductions in earnings accumulation and income from philanthropy, caused in major part by Federal government reimbursement and tax policies, debt financing will become even more important in the future. Restricting the access of tax-exempt hospitals to the tax-exempt market would make it extremely difficult for many hospitals to finance these projects. This inability to undertake needed capital improvement projects would reduce the quality of patient care in a hospital's service areas and shift the burden of health care to other area institutions, especially already hard pressed public hospitals.

Those hospitals able to finance at taxable rates would suffer cash flow problems and incur higher interest expenses, thus increasing the reimbursement expenses of Federal, state and local governments under Medicare, Medicaid, and other assistance and insurance programs.

The ability of the tax-exempt sector of the healthcare industry to raise needed capital has been severely and disproportionately impaired by actions of the Federal government and by the state of the bond market. Further impediments would not materially advance the budget, health, tax or credit policy goals advanced as justification for restriction on tax-exempt hospital financing and would substantially impair the ability of the private, not-for-profit sector of the healthcare system and the system as a whole to maintain the hard-earned level of health care. □

The author is indebted to Paul C. Fiduccia, an attorney with the Washington, D.C., office of Winston & Strawn, for his invaluable assistance in preparing this article.

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For further discussion, please contact:

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Chairman ROSTENKOWSKI. The Chair calls Mr. Davis and Mr. Arbib. Welcome to the committee, gentlemen.

Mr. Davis, if you would proceed with your testimony, the committee is ready to receive it.

STATEMENT OF STUART A. DAVIS, MEMBER, NATIONAL ASSOCIATION OF REALTORS, ST. LOUIS, MO.

Mr. DAVIS. Thank you. I am Stuart Davis, from St. Louis, Mo. I am a member of the legislative steering committee of the National Association of Realtors and I formerly served on the President's Commission on Housing.

On behalf of the more than 600,000 members of the National Association of Realtors, we greatly appreciate the opportunity to present our views in support of legislation to permit the continued availability of mortgage revenue bonds, H.R. 1176, and also to comment on H.R. 1635, legislation which would place unnecessary further restrictions on the use and benefits of industrial development bonds.

My oral statement will focus on H.R. 1176. With your permission, I would like to submit a complete written statement on the benefits of mortgage revenue bonds in which we will also present the National Association of Realtors position on H.R. 1635.

Chairman ROSTENKOWSKI. Without objection.

Mr. DAVIS. We appreciate the Ways and Means Committee holding this hearing and for recognizing the importance of the mortgage revenue bond program. We commend Representatives Downey and Frenzel for introducing H.R. 1176, together with their 312 colleagues who cosponsored this very important legislation. Mr. Chairman, the MRB program provides a major housing opportunity for families unable to secure home financing in the conventional mortgage market—particularly during times of high interest rates. As the program currently exists, States and localities have great flexibility in designing home financing programs to respond to changes in the housing market. Clearly, the wisdom of the program is in its ability to function as a countercyclical financing device and to provide the much needed affordable housing capital when high interest rates threaten to price families out of the housing market.

For example, Mr. Chairman, during much of 1982, high interest rates drove up the cost of home ownership and reduced the ability of families to secure financing.

However, the mortgage revenue bond program was able to provide for over $8 billion in 1982, up from $2 billion in 1981, in otherwise unavailable and much needed housing capital. These proceeds were used in 1982 to purchase over 150,000 homes creating 100,000 new jobs and generating an estimated $600 million in tax revenues.

Because these mortgage revenue bonds were available, thousands of individuals were able to purchase homes who otherwise could not have purchased a home.

I would like to refer to page 7 of our written statement. Here it is evident that mortgage revenue bonds not only provide assistance to those potential home buyers priced out of the conventional market, but they also enable existing home owners to move up to new homes. This occurs because a mortgage revenue bond beneficiary may purchase the home of a nonbond beneficiary who then goes on to purchase another home. The total economic contribution from these multiple sales and resales is demonstrated by the tables on page 7.

I would like to note that the National Association of Realtors supported the modest program changes Congress made last year including limitation changes in arbitrage, first time home buyer and purchase price. We now urge the Congress to continue the program as it currently exists. The changes enacted last year enabled the MRB program to react to local housing market needs. We would oppose any changes in the program to establish Federal or nationwide income qualification limits.

Congress wisely rejected Federal income limits last year because housing costs and incomes vary widely from State to State and to impose Federal income qualifications on the program would clearly reduce the ability of individual States to respond to local housing needs.

I should comment that while some MRB critics may suggest an alternative program to be implemented through direct Federal subsidies to qualifying home buyers, we would suggest that direct Federal involvement in these programs generally results in increased administrative costs, as well as a loss of local flexibility in meeting housing needs.

At this time, the existing mortgage revenue bond program has proven its countercyclical benefits and we therefore oppose the program's sunset or alteration.

Mortgage revenue bonds provide home mortgage interest rates about 2 percentage points below the conventional market and even lower in high interest rate periods. This is often the difference between purchasing and not purchasing a home.

Mr. Chairman, the projected record deficits present the very real possibility that the current U.S. economic outlook will demand a bottoming out of interest rates during 1983 followed by increased interest rates, some of which have already begun to ease upward. Evidence is FHA, VA, and now FNMA.

Our in-house economists predict new home mortgage rates of 12.9 in 1983 and 12.93 in 1984 increasing to nearly 14 percent in 1985.

These estimated rates assure that home ownership affordability will continue as a significant problem throughout the decade and assure the continued significant need for the mortgage revenue bond program.

The National Association of Realtors believes that allowing the mortgage revenue bond program to expire now would be premature. The association is very concerned over the projected future budget deficits and we are not convinced that interest rates will not again increase in the very near future.

We, therefore, support the elimination of the December 31, 1983 sunset date. Elimination of this sunset would allow for the continued availability of mortgage revenue bonds as a device to provide low-cost single-family home financing in times of high and rising interest rates.

This concludes our statement, Mr. Chairman, and we would be happy to respond to any questions you might have.

Mr. RANGEL [presiding]. Thank you, Mr. Davis.
[The prepared statement follows:]

STATEMENT ON BEHALF OF THE NATIONAL ASSOCIATION OF REALTORS® PRESENTED BY STUART A. DAVIS

My name is Stuart A. Davis. I am a member of the Legislative Committee of the National Association of Realtors® and a former member of the President's Commission of Housing. I am from St. Louis, Missouri.

On behalf of the more than 600,000 members of the National Association of Realtors®, we greatly appreciate the opportunity to present our views in support of legislation to permit the continued availability of mortgage revenue bonds, H.R. 1176, and also to comment on H.R. 1635, legislation which would place unnecessary restrictions on the use and benefits of industrial development bonds.

The majority of my statement will focus on H.R. 1176. Regarding H.R. 1635, we worked with the last Congress to establish reasonable restriction on perceived industrial development bond abuses. The National Association of Realtors® is again willing to work towards the elimination of program abuses and we support those provisions of H.R. 1635 which would deny tax exempt status to bond proceeds directly or indirectly receiving the insurance of the Federal government (the so-called FSLIC bonds). We do not, however, support those provisions of H.R. 1635 which would stretch out the real property depreciation period for projects financed with industrial development bonds (IDBs) or those provisions providing a capital expenditure limit on firms qualifying for industrial development bond small issues.

Real property financed with industrial development bonds is already denied the benefits of accelerated depreciation, and we believe lengthening the depreciation recovery period on these projects would further discriminate unnecessarily against industrial development bond-financed property.

Restricting IDB use to businesses with less than $20 million in capital expenditures during the 3 years to the bond issue and with no more than $20 million in IDBs outstanding worldwide discriminates against capital intensive companies, particulalry high technology firms, whether they are small, medium or large. This recommendation is an overly harsh solution to what is a non-problem.

In spite of the assertions of some critics, industrial development bonds largely benefit small businesses. While some large companies have used IDBs effectively to construct new, economically productive facilities which in turn have created new jobs, the Congressional Budget Office concludes that 93 percent of the small issues approved in 1978 and 1979 (the latest years for which CBO has compiled data) went to companies that were outside the Fortune 1000 industrial firms or the Fortune 50 non-industrial companies. We therefore do not see the necessity for these provisions.

SUMMARY POSITION ON MORTGAGE REVENUE BONDS

The mortgage revenue bond program provides a major housing opportunity for families unable to secure home financing in the conventional mortgage market. As the program currently exists, states and localities have great flexibility in designing home financing programs to respond to changes in the economic climate and the housing market. Clearly, the wisdom of the revenue bond program is in its ability to function as a counter cyclical financing device and to provide much needed affordable housing capital when high interest rates threaten to price families out of the housing market.

For example, during much of 1982 high interest rates drove up the cost of homeownership and reduced the ability of families to secure financing in the private sector. However, the mortgage revenue bond program was able to provide over $8 billion (up from $2 billion in 1981) in otherwise unavailable, and much needed, home financing capital. These bond proceeds were used to purchase approximately 80,000 new and 100,000 existing single family homes resulting in nearly 100,000 new jobs and $800 million in taxes. Because of mortgage revenue bond availability, homeownership affordability became more than an elusive dream for thousands of individuals who otherwise could not have purchased a home.

We supported the modest program changes Congress made last year including slightly reducing the arbitrage, first time homebuyer and purchase price limitations and we urge Congress to continue the program as currently existing. We would oppose any changes in the program to establish Federal nationwide income limits. Housing costs vary widely across the country and income limits, or to an extent greater state volume caps, would greatly reduce the ability of this program to work as designed during tight credit markets.

Now that interest rates have decreased somewhat, mortgage revenue bond opponents suggest that the program may no longer be needed and that Congress should allow the program to sunset as scheduled on December 31, 1983.

The National Association of Realtors® believes that allowing this form of homeownership assistance to expire now would be premature. The Association is very concerned over the projected future budget deficits and we are not convinced that interest rates will not again increase in the near future. We therefore support the elimination of the December 31, 1983 sunset date which would allow for the continued availability of mortgage revenue bonds as a device to provide low-cost single-family home financing during times of high or rising interest rates.

H.R. 1176

We appreciate the Ways and Means Committee holding this hearing and for recognizing the need for continuing the mortgage revenue bond program. We also commend Representatives Downey and Frenzel for introducing H.R. 1176 and their 312 colleagues who have co-sponsored this legislation.

H.R. 1176 would simply repeal the provision in the present tax code which denies the tax exemption for interest on qualified mortgage bonds issued after December 31, 1983. (IRC Section 103 A(c)(1)(B). Thus, the bill would continue into the future the availability of mortgage revenue bonds.

REASONS FOR SUPPORTING H.R. 1176

The mortgage revenue bond program was established to help those potential homebuyers who otherwise could not qualify for home financing from more traditional private sector sources. In other words, those individuals who were priced out of the conventional mortgage market; usually by hight interest rates.

Mortgage revenue bonds traditionally provide home mortgage interest rates about 2 percentage points below the conventional market and even lower during the very high interest rate periods. This two percentage point reduction is very often the difference between purchasing or not purchasing a home.

For example, the following table shows that it takes almost $28,000 in income to buy a $60,000 house at 13 percent interest, while a family with income less than $25,000 could buy the same house at 11 percent.

ANNUAL INCOME NEEDED TO SUPPORT MONTHLY HOUSING COSTS [1]

Interest rate	Purchase price [2]		
	$40,000	$60,000	$80,000
9 percent	$15,571	$21,358	$27,146
11 percent	17,696	24,546	31,395
13 percent	19,909	27,866	35,823
15 percent	22,186	31,281	40,376
17 percent	24,505	34,760	45,014

[1] Income estimates based on the following assumptions: 90 percent loan to value ratio: 30 year mortgage term: other housing expenses (taxes and insurance) estimated at $100 per month; and 30 percent housing expense to income ratio.

[2] The weighted average sales price for new and existing homes in the United States in 1982 was $81,000.

In 1982, when the spread between mortgage revenue bond loans and conventional mortgages averaged 3.8 percentage points, the effect on homeownership affordability was even more dramatic.

The average purchase price of homes financed in 1982 with mortgage revenue bonds was $48,000. Without mortgage revenue bonds a potential homebuyer would have needed more than a $24,000 income, while mortgage revenue bonds enabled an income of approximately $20,000 to qualify for that same home purchase.

It should also be noted that the average purchase price of all homes in 1982 was $81,500. Thus, mortgage revenue bonds financed home purchases costing almost 60 percent less than the national average.

Mortgage revenue bonds not only provide assistance to those potential homebuyers priced out of the conventional market, but they also enable existing homeowners move up to new homes. This occurs because a mortgage revenue bond beneficiary may purchase the home of a non-bond beneficiary who then goes on to purchase another home. The total economic contribution from these multiple sales and resales is demonstrated by the following tables.

Each 1982 resale resulted in almost $11,000 of direct expenditures and over $5,000 of secondary expenditures. Together, these expenditures totaled over $16,000 in contribution to GNP per resale transaction.

GNP resulting from the average single-family resale:	
Expenditures before resale	$830
Expenditures at time of sale	7,900
Expenditures after the sale	1,660
Mortgage insurers' income and lenders' income net of cost of funds	500
Subtotal	10,900
Multiplier effects	5,440
Total	16,340
Total resales and GNP 1982:	
Total home resales	1,990,000
Dollar contribution from direct expenditures (billion)	21.7
Dollar contributions from multiplier effects (billion)	10.8
Total dollar contribution (billion)	32.5

The recent slight recovery of housing markets and the improved homeownership affordability situation is due to the decline in conventional mortgage interest rates, relatively stable home prices and modest gains in family income. These events have combined to produce ten consecutive months of improving homeownership affordability. In March, the Housing Affordability Index, developed by the National Association of Realtors®, stood at 81.8, which means that a family earning the median income of $24,150 had 81.8 percent of the income needed to qualify for the purchase of a median-priced existing single-family home. This is an improvement over May of 1982 when the Affordability Index stood at its lowest point of 65.2 percent and when conventional mortgage rates exceeded 16 percent.

HOUSING AFFORDABILITY INDEX

	Median-priced existing home	Mortgage rate	Monthly P&I payment	Payment as percent of income	Median family income	Qualifying income	Affordability index (percent)
1977	$42,900	9.02	$277	20.7	$16,010	$13,279	120.6
1978	48,900	9.58	330	22.4	17,640	15,834	111.4
1979	55,700	10.92	422	25.7	19,680	20,240	97.2
1980	62,200	12.95	549	31.3	21,023	26,328	79.9
1981	66,400	15.12	677	36.3	22,388	32,485	68.9
1982	67,800	15.38	702	35.4	23,800	33,713	70.6
1982:							
March	67,000	15.65	706	37.2	22,741	33,873	67.1
April	67,100	16.00	722	37.9	22,859	34,650	66.0
May	67,800	16.11	734	38.3	22,976	35,242	65.2
June	69,400	15.56	727	37.8	23,094	34,893	66.2
July	69,200	15.52	723	37.4	23,212	34,707	66.9
August	68,900	15.59	723	37.2	23,329	34,706	67.2
September	67,300	15.27	692	35.4	23,447	33,236	70.5
October	66,900	14.95	675	34.4	23,565	32,380	72.8
November	67,700	14.29	654	33.1	23,682	31,401	75.4
December	67,800	13.95	641	32.3	23,800	30,609	77.4
1983:							
January	68,100	13.54	626	31.4	23,917	30,035	79.6
February [1]	68,200	13.40	621	31.0	24,033	29,791	80.7
March [2]	69,300	13.04	615	30.6	24,150	29,520	81.8

[1] Revised.

[2] Preliminary.

The National Association of Realtors®' Affordability Index disagrees with a preliminary report released by the General Accounting Office which states: "three-quarters of the buyers (in 1982) had income above $20,000 and could likely have purchased homes" without the availability of mortgage revenue bonds. the Affordability Index shows that in 1982 the median-priced existing home was $67,800—and the Affordability Index was 70.6 percent—meaning that a family earning $23,800 had only 70 percent of the income needed to quality for that home purchase.

Our research shows this family could only afford a $38,000 mortgage. While families may in theory have been able to purchase a lower priced home, in many markets, homes may not have been available for a lower price or suitable to the families' needs. The following table shows that nationwide only about 16 percent of the homes for sale in June 1982 were affordable to the median income mortgage bond borrower ($24,200) at the 15.38 percent interest rate available in the private sector.

SALES OF EXISTING SINGLE-FAMILY HOMES FOR THE UNITED STATES AND EACH REGION, BY PRICE CLASS, 1982

[Percentage distribution]

Price class	United States	Northeast	North Central	South	West
$19,999 or under	2.9	2.1	6.0	2.2	0.6
$20,000 to $29,999	4.7	4.2	8.3	4.2	.9
$30,000 to $39,999	8.8	10.0	12.7	9.2	1.9
$40,000 to $49,999	11.9	14.7	15.2	12.5	4.3
$50,000 to $59,999	12.5	14.4	15.1	13.0	6.7
$60,000 to $69,999	11.7	13.0	12.9	12.4	8.2
$70,000 to $79,999	9.9	10.3	9.4	10.5	9.2
$80,000 to $89,999	8.1	7.5	6.7	8.2	10.3
$90,000 to $99,999	5.8	5.0	4.0	5.8	8.9
$100,000 to $119,999	7.8	6.0	4.1	7.6	14.4
$120,000 to $159,999	8.8	7.1	3.7	8.4	17.7
$160,000 to $199,999	3.4	2.9	1.1	2.9	7.6
$200,000 to $249,999	1.9	1.4	.5	1.5	4.7
$250,000 and over	1.8	1.4	.3	1.6	4.6
Total	100.0	100.0	100.0	100.0	100.0
Median price	$67,800	$63,500	$55,100	$67,100	$98,900

Source: "Existing Home Sales 1982," National Association of Realtors®.

Despite recent economic improvements there is no reason to be concerned about near-term future homeownership affordability. Interest rates have fallen but real long-term interest rates, the level of interest rates above the inflation rare, remain at historically high levels. The primary factor behind these high real rates is the prospect of federal budget deficits in excess of $200 billion per year for the foreseeable future. Borrowing to finance deficits this size has placed and will continue to place upward pressure on interest rates and is "crowding out" the demand for credit by consumers and businesses. Further, credit markets continue to expect a resurgence of inflation since the Federal Reserve Board is under immense political pressure to lower interest rates by increasing the supply of money much faster than its stated target growth rates. Resolution of the current federal budget stalemate through substantial spending cuts would ease both the total demand for credit and the expectations of future inflation and allow further declines in long-term rates.

These projected record deficits present the very real possibility that the current U.S. economic outlook will include a slowly declining level of interest rates throughout 1983 and 1984 followed by increased interest rates beginning in 1985. For example, the National Association of Realtors®' financial market forecasting model predicts "new home mortgage rates" of 12.97 percent in 1983 and 12.94 percent in 1984, increasing to 13.77 percent in 1985. These estimated mortgage rates assure that homeownership affordability will continue as a significant problem throughout the rest of the decade. The program has shown its ability to provide housing capital when private interest rates price families out of the market. We therefore believe that sunsetting the mortgage revenue bond program now would be premature.

We also should comment that while some mortgage revenue bond critics may suggest an alternative program implemented through direct federal subsidies to qualifing homebuyers, we would have to question the increased administrative costs as well as the loss of local flexibility in meeting housing needs. We would however not oppose a Congressional or Treasury study of alternative, similarly targeted, programs. Even so, at this time the existing mortgage revenue bond program has proven its counter cyclical benefits and we oppose its direct elimination.

CONCLUSION

The National Association of Realtors® believes that in the long run, residential mortgage financing ideally should be provided by the private sector of the economy. However, even though interest rates began declining early this year, interest rates on FHA, VA and other loans have now again begun to edge upward. Conventional mortgage rates will very likely follow. In order to meet housing credit demands during this period of rising interest rates we strongly urge that Congress enact H.R. 1176 and allow the existing mortgage revenue bond program to continue.

The National Association of Realtors® is comprised of more than 1,806 local boards of Realtors® located in every state of the Union, the District of Columbia, and Puerto Rico. Combined membership of these boards is over 600,000 persons actively engaged in sales, brokerage, management, counselling, and appraisal of residential, commercial, industrial, recreational and farm real estate. The activitie's of the Association's membership involve all aspects of the real estate industry, such as mortgage banking, home building, and commercial and residential real estate development, including development, construction and sales of condominiums. The Association has the largest membership of any association in the United States concerned with all facets of the real estate industry.

Elected Officers are: President Harley W. Snyder, Valparaiso, Indiana; President-elect Donald H. Treadwell, Sr., Southgate, Michigan; First Vice President David Roberts, Mobile, Alabama; Treasurer Budd Krones, Tucson, Arizona.

The Chief Administrative Officer is Jack Carlson, Executive Vice President and Chief Economist.

The Senior Vice President, Government Affairs is Albert E. Abrahams and the Vice President and Legislative Counsel, Government Affairs is Gil Thurm.

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STATEMENT OF JOHN ARBIB, CHAIRMAN, MORTGAGE FINANCE SUBCOMMITTEE ON STATE AND LOCAL HOUSING FINANCE AGENCIES, NATIONAL ASSOCIATION OF HOME BUILDERS, AND CHAIRMAN, FLORIDA HOUSING FINANCE AGENCY

Mr. RANGEL. Mr. Arbib.

Mr. ARBIB. Thank you, Mr. Chairman, for this opportunity. I am John Arbib, a home builder from Pembroke Pines, Florida. I am also chairman of the National Association of Home Builders' Mortgage Finance Subcommittee on State and Local Housing Finance Agencies as well as chairman of the Florida Housing Finance Agency. I am presenting this statement on behalf of the more than 110,000 members of the National Association of Home Builders. NAHB is a trade association of the nation's home building industry.

I would like to express my appreciation to Representatives Downey and Frenzel for their leadership on this particular issue. MRB's represent an efficient program for helping moderate income households gain a foothold in home ownership. MRB's have successfully filled the affordability gap for hundreds of thousands of first-time home buyers. Assertions that these bonds help people who could have purchased homes without this assistance simply ignore the realities of the housing market. The median income of State mortgage bond beneficiaries was $18,500 in 1981, and $23,500 in 1982.

The median income of households receiving FHA loans in 1982 was about $10,000 above the mortgage bond program level of $33,000, and the median income of households receiving conventional mortgage loans was about $20,000 above MRB levels, at $39,000, in 1981.

In 1982, when conventional mortgage rates averaged 16.2 percent, a family with an income of $23,500 could have afforded a $36,000 mortgage. Although there are millions of households with modest incomes that would like to own homes, only 16 percent of all existing homes sold in 1982 had a purchase price of below $40,000. In most areas, it would be impossible to find a new home with a sales price of $40,000 or less.

The assertion that first-time homebuyers use the benefit of MRB financing to buy a larger house ignores the fact that bond-financed housing is among the lowest priced non-subsidized housing in the market. In 1982, the average new home sold had a price tag of almost $84,000 and the average existing home sold for $80,000. The average mortgage bond-financed home, however, had a price of under $49,000.

So, it appears to me that what GAO has said in its report is simply not true. We did reach the market during the times of the highest interest rates. We provided housing for families at almost half of what existing homes sold for without the bond program.

These bonds have provided a significant boost to the economy, particularly during the past 2 years while construction industry unemployment was at 20 percent and starts had dropped to a post-World War low. This construction was generating at least 37,000 jobs, $686 million in wages, and $310 million in Federal tax dollars.

This positive impact is actually understated since it is based only on an estimate of actual starts, does not account for economic activity produced by existing units, or the fact that builders started putting people back to work as soon as the MRBs were structured, even if some of the units were conventionally financed.

I would like to refer you to page 13 of the written testimony that shows that 1,000 units produce a positive direct impact of $88 million. That number does not take into account the ripple effect of all the furniture and household goods purchased and workers employed.

Mortgage bond programs work and they mut be allowed to continue.

I would like to respond for a moment if I could to the suggestion that this program operate according to an interest rate trigger mechanism. The trigger concept assumes that the only value of MRB programs is as a countercyclical tool. When interest rates are low, the MRB program is in fact better able to facilitate home ownership for lower-income households. I might say to you that the State agencies such as ours have a mandate to provide housing, not as a countercyclical measure. Our job is to provide housing for those who need it.

We can better serve this goal as interest rates go down. As conventional interest rates decline, we can assist a lower segment of the market who could not otherwise finance housing.

If we were to operate under a trigger, we would destroy our agencies and destroy the very mechanism that we have to produce the financing.

Let me conclude that in regard to the single-family mortgage revenue bonds, if it ain't broke, don't fix it. And it ain't broke. It is doing a very good job.

TEFRA helped us make the program viable again as it had been before and we really cannot do our job if restrictions such as a trigger are added.

I would just say two things with regard to the multi-family industrial development bonds. It is essential that we continue the current 15-year accelerated depreciation for projects financed with multi-family industrial development bonds as provided for in the Industrial Development Bond Limitation Act (H.R. 1635), and I would like to thank Congressman Pickle for including that exclusion in the bill.

Affordable rental housing is a scarce commodity these days and given the total absence of Federal production programs, there really is no substitute for the multi-family tax-exempt program. This is the only way that multi-family housing for low- and moderate-income people can be provided.

I thank you and I would be glad to answer any questions.

[The prepared statement follows:]

STATEMENT OF THE NATIONAL ASSOCIATION OF HOME BUILDERS (NAHB)

Mr. Chairman and members of the committee, my name is John Arbib and I am a homebuilder and developer from Pembroke Pines, Florida. I am also Chairman of the National Association of Home Builders' Mortgage Finance Subcommittee on State and Local Housing Finance Agencies as well as Chairman of the Florida Housing Finance Agency. I am presenting this statement on behalf of the more than 107,000 members of the National Association of Home Builders (NAHB). NAHB is a trade association of the nation's homebuilding industry.

Mr. Chairman, NAHB wholeheartedly supports The Housing Finance Opportunity Act of 1983, H.R. 1176, to repeal the sunset date on single family mortgage revenue bonds. I want to commend Representatives Downey and Frenzel for their leadership on this issue. The overwhelming support of the House for continuation of this program is clearly indicated by the 315 co-sponsors on H.R. 1176, 24 of whom are members of the House Ways and Means Committee. 77 members of the Senate have also co-sponsored the counterpart Senate bill, S. 137. In total, almost three-quarters of the Members of Congress have expressed their views in favor of the Housing Finance Opportunity Act of 1983.

We, strongly urge this Committee to seek early enactment of H.R. 1176. Expeditious passage of this legislation is necessary to allow states and localities sufficient time to plan and implement their housing programs.

NAHB also supports the exemption of multifamily housing from the proposed depreciation changes under H.R. 1635, the Industrial Development Bond Limitation Act of 1983. It is essential to assure that the tax-exempt multifamily program is viable, particularly in the absence of the Section 8 program or a similar federal rental production program. NAHB also supports the use of small issue industrial development bonds for job creating projects that are in the public interest, but restrictions included in H.R. 1635 would essentially terminate this program.

SINGLE FAMILY MORTGAGE REVENUE BONDS

Tax-exempt revenue bonds provide a major housing opportunity for low and moderate income families. Since the early 1970's, states and localities have provided financing for approximately 700,000 buyers of new and existing units. State Housing Finance Agencies located in 48 states, the District of Columbia, Virgin Islands and Puerto Rico, as well as hundreds of local housing agencies, are authorized to finance below market mortgages for primarily first-time homebuyers through the sale of tax-exempt bonds. In conjunction with the private sector, housing finance agencies target diverse programs financed with bond proceeds to address the needs of their low and moderate income families.

The following analysis details the social and economic benefits and costs of the mortgage revenue bond program. But first, Mr. Chairman, I would like to comment on a recent General Accounting Office Report, "The Costs and Benefits of Single Family Mortgage Revenue Bonds: Preliminary Report." Mr. Chairman, our research indicates that the GAO Report is inaccurate and misleading. I will not attempt a detailed rebuttal to the GAO Report at this time since attached to this testimony is a letter to the Chairman of the Senate Finance Committee, Senator Dole, which details the many methodological problems with this study. At this point, I will highlight some of the major faults of the GAO Report. The thrust of my testimony also addresses the costs and benefits of mortgage revenue bonds, some of which are also dicussed by GAO.

THE GAO REPORT

Given my experience with state and local housing finance agency programs, I was quite surprised to read the recent U.S. General Accounting Office Report concluding that mortgage revenue bond-financed homeownership programs are largely ineffective in aiding low and moderate income homebuyers. The report concludes that mortgage bond programs are from two to six times more costly than alternative homeownership assistance programs. This report also finds that these housing bonds drive up interest rates in the municipal credit market.

The GAO study is based on bonds issued from December 1981 to July 1982, a period in which interest rates reached the highest level since the Civil War. Beyond the fact that GAO has selected an inappropriate time to evaluate the effectiveness of mortgage revenue bonds in serving lower income households, GAO severely understates the benefits of mortgage revenue bonds and overstates the costs. Their analysis is both biased and misleading.

GAO criticizes the fact that the median income of mortgage bond program beneficiaries was about $23,500 during the period of this study. Considering that the median income of homebuyers receiving conventional loans in 1981 was $39,196, I would conclude that mortgage bond programs are very effectively targeted. Moreover the average price of a mortgage bond-financed home, according to GAO's own findings, was about 6 percent of the national average. How can GAO conclude that state income and federal purchase price limits on bond-financed housing are ineffective?

GAO somehow concludes that three out of every four mortgage revenue bond beneficiaries could have purchased a home without assistance in 1982. Mr. Chairman, with interest rates over 16 percent last year, very few households in the low $20,000 income range could find affordable housing.

The cost of mortgage revenue bonds is also greatly overstated by GAO because they employ an inflated cost calculation methodology and understate the actual interest rate reduction that is obtained by the issuance of mortgage bonds. GAO incorrectly assumes that every dollar invested in tax-exempt bonds displaces a dollar of investment in taxable corporate bonds. Other municipal finance experts calculate the expenditure cost of mortgage revenue bonds to be one-third of the GAO estimate. Furthermore, mortgage revenue bonds issued by state housing finance agencies in 1982 actually reduced interest rates by almost 4 percent, rather than 2½ percent as reported by GAO. Hence, GAO concludes that mortgage revenue bonds are more costly and less efficient than hypothetical program alternatives.

Finally, GAO concludes that the high volume of mortgage revenue bonds drives up municipal interest rates and costs states and local governments millions of dollars in high interest payments on tax-exempt borrowing. GAO not only overestimates the 1982 volume of single family mortgage revenue bonds by almost $2 billion, and their share of the municipal market, but the assumed credit market effects are not borne out by history. Despite the development of mortgage revenue and industrial development bonds in the early 1970's, the spread between taxable and tax-exempt bonds is currently the same as it was 20 years also.

In general, the GAO Report is flawed to the point that I doubt it will be useful in honestly evaluating the costs and benefits of mortgage bonds.

SOCIAL AND ECONOMIC BENEFITS OF MORTGAGE REVENUE BONDS

Affordability.—Revenue bonds address housing needs not served by the coventional market by reducing mortgage interest rates by 2–3 percent below conventionally financed mortgages, and even more when conventional rates are inordinately high. During 1982, for instance, the average interest rate for State Housing Finance Agency mortgages was 12.48 percent. This interest rate was almost 4 percent below conventional rates for that time period. This substantial spread in interest rates qualifies many additional moderate income households for mortgage loans. Over 6.5 million additional working families are able to purchase a home with a 12.5 percent revenue bond mortgage rate when conventional rates are 16.5 percent, since monthly payments are reduced by $133 per month. As interest rates continue to drop, mortgages financed with revenue bonds are able to serve an even larger segment of the targeted population.

More specifically, the Council of State Housing Agencies found the median income of mortgage bond programs beneficiaries to be $18,467 per year in 1981 and $23,511 per year in 1982. (This is based on a sample of 12 State Housing Finance Agencies, stratified by region, age of agency and debt outstanding.) In contrast, the U.S. League of Savings Associations reports that the median income of homebuyers receiving conventional loans in 1981 was $39,196.

According to the GAO, the average purchase price of homes financed by mortgage revenue bonds in 1982 was $48,800. In 1982, the average purchase price of a new and existing home was $83,900 and $80,500, respectively. Thus, housing financed by mortgage bonds was about 60 percent than the national average in 1982.

According to GAO, $43,300 was the 1982 average revenue bond mortgage amount. Given a 1982 average conventional mortgage interest rate of 16.20 percent, an income of over $28,000 per year would be required to qualify for this mortgage. Alternately, a family earning $22,000 per year would qualify for this same mortgage, financed with mortgage revenue bonds, because of the substantial reduction in the interest rate.

To what extent, Mr. Chairman, was affordable housing available to moderate income homebuyers in 1982? At the average 1982 conventional mortgage rate of 16.2 percent, a family earning $23,500 per year could afford only a $36,000 mortgage. However, there was very little decent housing available for less than $40,000 last year. In fact, there were only 66,000 new homes built in 1982 for under $50,000 and only 16.4 percent of all existing homes sold for less than $40,000. The limited number of homes priced at these levels provides the moderate income homebuyer with little or no opportunity to choose how or where to live even if affordable housing can be found.

Targeted program.—The Mortgage Subsidy Bond Tax Act of 1980 ensures that mortgage revenue bonds serve a legitimate public purpose by imposing strict limits on both recipients served and homes financed by the program. Federal law directs proceeds to mostly first-time homebuyers, specifies purchase price limits and encourages lending in distressed areas. Furthermore, most states and localities establish income limits and other targeting requirements to meet regional housing objectives.

New Federalism tool.—At a time when the federal government is increasing its reliance on state and local governments to provide traditional forms of federal assistance, it does not make sense to eliminate a program which is fulfilling this goal. By utilizing the mortgage revenue bond program, states and localities were successfully practicing the "new federalism" long before this term was coined.

Revenue bonds have provided states and localities with the flexibility to design programs to respond to changes in the housing market. In this way, housing agencies maintain the efficiency and effectiveness of their programs. For instance, in order to respond to the rising yield curve present in the tax-exempt bond market in 1981 and the first half of 1982, housing agencies replaced 30-year bonds with shorter-term securities to reduce the cost of borrowing. New mortgage instruments were simultaneously developed, such as the growing equity mortgage, in lieu of the traditional 30-year fixed-rate Mortgage. Housing agencies are now in a unique position to combine different bond structures and security instruments to respond to changing economic climates, as was demostrated during the latter half of 1982 when interest rates declined. This, a variety of lower cost financing programs can be provided.

In addition to ownership assistance, housing finance agencies have successfully developed other bond-financed programs to meet the special needs of their residents. Home improvement, energy conservation and other programs targeted to the elderly and handicapped are just a few examples of the innovative capability of housing agencies. A strong state and local role in housing is undoubtedly in the national interest.

Housing activity generated by mortgage revenue bonds.—Since the early 1970's, states and localities have provided below market rate loans to finance nearly 700,000 new and existing homes for primarily first-time homebuyers through the use of revenue bonds. One billion dollars in bonds provides financing for approximately 20,000 units, about one-third of which are newly constructed units. 1982 bond proceeds totalling more than $8 billion provided financing for almost 100,000 units. 35,000 of these were new units, which represented approximately 8.5 percent of all new single family sales.

SOCIAL AND ECONOMIC COSTS OF REVENUE BONDS

Interest rate effects.—Opponents of revenue bonds contend that municipal interest rates are adversely affected by an increase in the supply of these bonds. Consequently, other municipal borrowers are driven out of the market. This impact of housing bonds on the market, however, has been restricted by Congressionally imposed volume caps. Congress limited the annual issuance of housing bonds from 1981 to 1983 to $10–$15 billion, but so far less than one-half of this volume has actually been used. In 1982, for example, single family revenue bond issuance totalled approximately $8.1 billion, representing approximately 10.5 percent of the municipal market, and 60 percent of the authorized mortgage bond volume. 1981 volume amounted to less than 20 percent of the authorized volume.

Furthermore, the credit market impact of housing bond volume has been overstated. Critics contend that the spread between municipal bond and taxable bond interest rates has been reduced due to the growth of tax-exempt bonds. Even though municipal bond volume increased dramatically in the 1970's and 1980's, the comparable taxable/tax-exempt interest rate spread is the same as it was twenty years ago.

One overstated estimate of the adverse effect of revenue bonds on other municipal interest rates is George Peterson's conclusion, in the 1979 Urban Institute Report entitled "Tax-Exempt Financing of Housing Investment," that each $1 billion of bonds increases tax-exempt rates by four to seven basis points. Peterson assumes that an increase in tax-exempt volume continually attracts lower marginal racket taxpayers away from their taxable investments because higher bracket taxpayers have absorbed as much tax-exempt debt as they can afford. Subsequently, tax-exempt interest rates must increase to attract the lower marginal bracket investors.

Peterson, however, ignores the fact that investors purchase bonds for other reasons than rate of return, such as their role in a total portfolio and their relative risk. Thus, tax-exempt bonds are not necessarily purchased by only investors at the margin. As a matter of fact, Professors Roger Kormendi and Thomas Nagle contend that 83 percent of all increases in tax-exempt volume are purchased by above-margin taxpayers. (See Roger C. Kormendi and Thomas T. Nagle, University of Chicago, "The Interest Rate and Tax Revenue Effects of Mortgage Revenue Bonds", April 1980). They estimate that each billion dollars of bonds increases tax-exempt rates by only one basis point or about one-quarter of the Peterson estimate.

It seems that demand for tax-exempt bonds is equally, if not more, responsible than volume for municipal interest rate levels. In recent years, factors affecting demand for municipal bonds and adversely affecting interest rates include: reduction in the maximum income tax bracket from 70 to 50 percent, thereby forcing an increase in municipal rates to attract investors; creation of additional competition in the tax-exempt market caused by an increase in tax-exempt or partially tax-exempt investments created by the 1981 Tax Act, such as All-Savers certificates and safe harbor leases; and a major decrease of institutional investors in tax-exempt bonds in the past couple of years.

Efficiency of bonds.—Some suggest that a more cost-effective direct subsidy could provide the same benefits as mortgage revenue bonds. It is argued that revenue bonds are inefficient because, in order to attract marginal investors who demand higher tax-exempt rates, they inadvertently provide windfalls to high income investors.

This rationale has two flaws. First, it is evident during this time of fiscal constraint that an alternative direct subsidy will not be forthcoming. Even if implemented, however, a direct federal subsidy will not only be more costly, due to an increase in administrative costs, but will also deprive states and localities of the considerable flexibility they now exercise to respond to regional housing needs. In addition, the change in the tax rate on unearned income from 70 percent to 50 percent reduces the benefit to high tax bracket investors.

Revenue loss to treasury.—The Joint Committee on Taxation recently released preliminary revenue loss estimates for continuation of the mortgage revenue bond program. The Committee estimates that the program will result in a revenue loss of $59 million in fiscal year 1984, and totally $2.159 billion for a five year period through fiscal year 1988. Based on the Committee's economic assumptions, it can be estimated that the federal government will lose a little more than $20 million per year for every billion of revenue bonds issued through fiscal year 1988.

This analysis, however, incorrectly assumes that every dollar invested in tax-exempt bonds displaces a dollar of investment in taxable bonds. This unrealistic assumption fails to account for net new savings going into tax-exempt bonds and substitutions of lesser taxed investments for tax-exempt bonds. Investors are likely to exchange tax-exempt or partially taxable assets to purchase revenue bonds. Thus, the revenue loss is significantly less than estimated by the Joint Tax Committee. In fact, other municipal finance experts indicate that the revenue loss is approximately one-third the amount calculated by the Joint Committee on Taxation.

This estimated revenue loss also ignores the positive economic impact of revenue bonds. One billion dollars in revenue bonds, which provides financing for approximately 7,000 newly constructed units, generates about $140 million in wages by creating about 7,500 jobs in construction, land development, manufacturing, wholesale trades, transportation, mining and other industries directly related to the homebuilding process. These units also generate over $62 million in federal, state and local taxes. The total positive economic impact is estimated at $619 million. (The economic impact of $1 billion of revenue bonds is actually understated since it is based on benefits derived only from new construction, and not from existing units.) The table attached to my testimony describes the economic impact of 1,000 new single family units financed by revenue bonds.

Thus, Mr. Chairman, NAHB concludes that the benefits of mortgage revenue bonds more than outweigh the costs. We believe that the December 31, 1983 sunset date should be repealed to help thousands of first-time homebuyers each year achieve the dream of homeownership.

ECONOMIC IMPACT OF 1,000 NEW SINGLE FAMILY UNITS FINANCED BY TAX-EXEMPT MORTGAGE REVENUE BONDS

[Average value per unit—$50,000]

	Man-years [1]	Wages
Employment impact:		
Construction:		
On site	316	$6,891,400
Off site	61	1,301,200
Total	377	8,192,600
Other industries:		
Manufacturing	239	3,873,400
Wholesale trade, transportation and services	214	2,777,100
Mining and all others	87	1,759,000
Total	540	8,409,500
Land development	142	3,000,000
Total all industries	1,060	19,602,100
Taxes:		
Tax impact		
Federal taxes:		
Federal personal income tax		2,463,800
Federal corporate income tax		2,554,200
Social security tax		2,607,200
Total		7,625,200
State personal income tax		331,300
Local real estate tax		909,600
Total tax impact		8,866,100
Total economic impact [2]		88,495,600

[1] A man-year equals 1 job for 1 man for 1 year.

[2] The total economic impact is derived from taking the value of the units, subtracting the value of the raw land, and employing a multiple of 2 to reflect additional economic activity generated.

Source: NAHB Economic Policy Analysis Division.

MULTIFAMILY INDUSTRIAL DEVELOPMENT BONDS

It is essential to continue the current 15 year accelerated depreciation for projects financed with multifamily industrial development bonds as provided for in the Industrial Development Bond Limitation Act, H.R. 1635. This bill exempts residential rental property financed with industrial development bonds from the proposed extended recovery periods.

Mr. Chairman, affordable rental housing has become a scarce commodity in many areas of the country. The national vacancy rate is 5.7 percent, but is much less in many large urban markets. Uriel Mannheim, a respected housing economist, projects the demand for new multifamily rental units at 350,000 per year during this decade. 167,000 units were constructed in 1981 and 206,000 units were built in 1982, resulting in a shortfall of more than 150,000 units per year. And about one-third of the units built each year were built under the Section 8 program, now targeted for extinction.

The multifamily rental construction market is in a seriously depressed state. Essentially no units below the luxury market are being built without government assistance. Low income housing construction currently requires tenant rental subsidies, which have been virtually eliminated, and either tax-exempt or other federal assistance for the permanent mortgage.

In the absence of the Section 8 program or a similar federal production program, it is essential to assure that the tax-exempt program is viable and self-sustaining. A major factor in the shortage of rental housing is simply the tenant's inability to pay sufficient rent to cover the building's debt service payment and its operating expenses. For the foreseeable future, tax-exempt financing may provide the only means to build rental housing in this nation for low and moderate income households.

The Mortgage Subsidy Bond Tax Act of 1980 required that 20 percent of the units of a multifamily dwelling (15 percent in targeted areas) be setaside for low-moderate income households. The Tax and Equity Fiscal Responsibility Act of 1982 (TEFA) clarified this provision and added public reporting and approval requirements. Through a narrow interpretation of the legislation, the Treasury Department imposed additional constraints on this program and considerably revised proposed regulations after they were deemed unworkable. Given the public purpose served by constructing low and moderate income housing, I urge the Committee not to impose any additional restrictions on this program.

Small issue industrial development bonds.—NAHB supports the use of tax-exempt industrial revenue bonds for job creating projects that are in the public interest. The Industrial Development Bond Limitation Act includes many of the industrial development bond restrictions proposed by the Administration but rejected by Congress last year. These proposed changes, which inlcude a stretch-out in depreciation periods for industrial development bond financed projects, a $20 million limit on small issues outstanding at any time by a firm, a $20 million limit on the capital expenditure of a firm during the three-year period to the issuance of a small issue and a prohibition on the use of small issues to purchase land, would effectively eliminate the small issue industrial development bond program.

The restrictions placed on tax-exempt financing by both the Mortgage Subsidy Bond Tax Act of 1980 and the Tax Equity Fiscal Responsibility Act of 1982 limited the volume and types of projects financed by tax-exempt bonds. By imposing a volume cap, the Mortgage Subsidy Bond Tax Act of 1980 limited the annual issuance of single family housing bonds. TEFRA not only restricted the long-term growth of small issue industrial development bonds by enacting a 1986 sunset date, but also banned the most controversial small issues, reduced their depreciation benefits by replacing the accelerated cost recovery system (ACRS) with the straight-line method, and strengthened control of such financing by imposing public reporting and approval requirements.

Nevertheless, industrial development bond critics continue to advocate additional restrictions on industrial development bonds, contending that they negatively affect municipal interest rates and cost the Treasury too much money. Their contribution to a community's tax base and job creation is too often ignored. I have already presented a strong response to these assertions in regard to mortgage revenue bonds. A similar case can be made for those bonds which generate employment and revenue as well.

Direct federal aid to states and localities for most industrial development bond projects has dwindled. The cost of capital precludes conventional financing in many cases. Many companies will not be able to retool or expand without industrial development bonds, and others may even have to close. We believe that the ability of state and local governments to meet their financing needs through the municipal bond market must be allowed to continue.

Thank you for the opportunity to present our views on these issues. I would be pleased to answer any questions you may have.

National Association of Home Builders,
Washington, D.C. May 10, 1983.

Hon. Robert J. Dole,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.,

Dear Mr. Chairman: On behalf of the 110,000 members of the National Association of Home Builders, I am writing to convey our deep concern with a recent U.S. General Accounting Office report concluding that mortgage revenue bond-financed homeownership programs are largely ineffective in aiding low and moderate income homebuyers. ("The Costs and Benefits of Single Family Mortgage Revenue Bonds: Preliminary Report," April 18, 1983). The report also concludes that mortgage bond programs are from two to six times more costly than alternative homeownership assistance programs. As well, the report finds that these housing bond programs have had a significant negative effect by driving up interest rates in the municipal credit markets.

As you know, the National Association of home builders is a strong supporter of mortgage revenue bonds. We see mortgage revenue bonds as key means of helping first-time homebuyers achieve the dream of homeownership. The U.S. League of Savings Associations reports that first-time homebuyers have made up a successively smaller share of the market each year since 1977. There is a genuine need for a program to help our young people get a foothold in homeownership.

We believe that the GAO study is both biased and misleading. A major fault of the GAO report is that it is based on the period from December 1981 to July 1982, a period in which interest rates reached the highest levels since the Civil War. Because mortgage bond yields are related to market interest rates in general, the incomes of program beneficiaries had to be somewhat higher than in prior years. This letter reviews some of the other major faults in the report. A one-page attachment summarizes our concerns.

HOMEBUYERS ASSISTED BY MORTGAGE BOND PROGRAMS

Despite GAO's conclusions, the actual beneficiary income data cited by GAO indicate that mortgage revenue bond programs have been very successful in targeting their benefits to households that have been priced out of the homeownership market. Although GAO does not state what the median income of mortgage bond and FHA program beneficiaries actually was, the graph they supply on page 9 of Appendix II suggests that the median for the mortgage bond program beneficiaries was about $23,500 per year and the median for FHA borrowers was about $33,000 per year.

The Council of State Housing Agencies found the median income of mortgage bond program beneficiaries to be $18,467 per year in 1981 and $23,511 per year in 1982.[1] In contrast, The U.S. League of Savings Associations reports that the median income of homebuyers who received loans from S&Ls in 1981 was $39,196.

In 1982, the average purchase price of a new home in the United States was $83,900. The average price of an existing home was $80,500. GAO's finding that mortgage bond-financed housing had an average price of $48,800—about 60 percent of the national average—does not support GAO's conclusion that the purchase price limits on bond-financed housing are ineffective.

It seems to me that what we have here is a very successful program for helping modest income first-time homebuyers to buy a home. GAO's unsupported assumption that three out of four program beneficiaries would have purchased a home without assistance doesn't stand up under close scrutiny.

Given a 1982 mortgage rate of 16.2 percent, an income of over $28,000 per year would be required to afford a $43,300 mortgage (GAO found that the 1982 average loan financed through mortgage bonds was $43,300). The average 1982 mortgage bond program interest rate of 12.48 percent would make that same mortgage affordable to a family with an income of about $22,000 per year. At the average 1982 conventional mortgage rate of 16.2 percent, a family earning $23,500 per year could afford only a $36,000 mortgage. There was very little decent housing selling for less than $40,000 last year. In fact, there were only 66,000 new homes built in 1982 that had a purchase price under $50,000 and only 16.4 percent of all existing homes sold had a price below $40,000. How GAO can conclude that, in 1982, three out of every four households receiving mortgage revenue bond financed loans could have found an affordable home without mortgage bond financing is baffling to me.

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[1] Based on a sample of 12 state HFAs, stratified by region, age of agency and debt outstanding.

THE COST OF MORTGAGE BOND PROGRAMS

The General Accounting Office overstates the cost of mortgage revenue bonds by using an inflated cost calculation methodology and understating the actual interest rate reduction that is obtained by the issuance of mortgage bonds.

GAO assumes that every dollar invested in tax-exempt bonds displaces a dollar of investment in taxable corporate bonds. This unrealistic assumption fails to account for net new savings going into tax-exempt bonds and for substitutions of lesser taxed investments for tax-exempt bonds. For these reasons, and others, Professor Roger Kormendi of the University of Chicago calculates the revenue expenditure cost of mortgage bonds to be one half to one third the GAO estimate.

GAO also appears to understate the interest reduction provided by mortgage revenue bonds in order to make unfavorable cost comparisons with hypothetical program alternatives.

In the case of 1982 mortgage revenue bond mortgage interest rates, GAO assumes that the Daily Bond Buyer revenue bond index is a satisfactory proxy for mortgage bond rates during the year. This is a poor assumption because the net interest cost for single family mortgage bond issues consistently has been below the Bond Buyer index. The Council of State Housing Agencies maintains a comprehensive listing of state HFA mortgage bond issues. In 1982, the weighted average net interest cost of state housing finance agency issues was 11.92 percent, 57 basis points less than the GAO assumption. Based on a comprehensive listing of state HFA bond issues for 1982, the weighted average mortgage rate for 1982 programs was 12.24 percent.

GAO assumes an average spread of 243 basis points between mortgage bond programs and the conventional market in 1982. Taking the state agency average mortgage rate and factoring in two discount points, the effective mortgage rate of 12.48 percent is 127 basis points below the GAO estimate of 13.75 percent. This 370 basis point spread would increase the GAO calculation of the efficiency of mortgage bonds by 52 percent.

CREDIT MARKET EFFECTS OF MORTGAGE BONDS

GAO asserts that revenue bonds are adversely affecting the cost of other tax-exempt borrowing, First of all, GAO is wrong to assume the 1982 volume of tax-exempt single family bonds was $10 billion since the total volume was $8.1 billion. GAO asserts that housing bonds made up 30 percent of the municipal market in 1982. The Public Securities Association reports that long-term municipal bond volume totalled $77.3 billion in 1982. Our calculations indicate that single family bonds made up about 10.5 percent of the municipal market and all housing bonds made up about 17 percent of the market—not 30 percent as GAO asserts.

Second, GAO's calculation about the credit market effects of housing bond issues and the resultant costs to state and local government are not borne out by history. In 1962, when mortgage revenue bonds did not exist, interest rates on municipal bonds reached their lowest level in the past twenty five years and tax-exempts sold at 73 percent of the taxable rates. In 1980, when $10 billion in mortgage bonds were marketed and total municipal issues had quadrupled from 1962, the market offered a more favorable spread for municipal bonds—71 percent—than the golden days of 1962.

The Peterson study cited by GAO in their assessment of the credit market effects of mortgage bonds has questionable methodology. By isolating the tax-exempt bond market from the rest of the capital markets, Mr. Peterson greatly overstates the effect of changes in municipal volume on bond interest rates.

It appears that throughout the study GAO has looked for evidence to support its conclusions rather than attempt a balanced and useful evaluation. The GAO study is flawed to the point that NAHB doubts it will be useful in honestly evaluating the costs and benefits of single family mortgage revenue bonds.

When I first read the GAO report. I was surprised by the conclusions. Upon studying the methodology, I am now surprised that a Congressional support agency would publish such a report.

Please contact Bob Bannister, Senior Staff Vice President for Governmental Affairs (822-0470) if the National Association of Homebuilders can be of any further assistance.

Sincerely,

HARRY PRYDE, *President.*

Attachment.

THE COSTS AND BENEFITS OF SINGLE FAMILY MORTGAGE REVENUE BONDS: PRELIMINARY REPORT U.S. GENERAL ACCOUNTING OFFICE

GAO'S PRELIMINARY CONCLUSIONS

I. Beneficiaries of mortgage revenue bonds

Program is not targeted—recipients could have afforded homes without assistance given their average income of approximately $23,500 per year.

In 1982, the average purchase price of a home (new and existing) financed by mortgage revenue bonds was $48,800.

Three out of four program beneficiaries would have been able to purchase a home without government assistance.

II. Cost of mortgage revenue bonds

The Treasury will lose approximately $13,300 per loan for revenue bond financed housing in 1982.

By assuming a revenue bond average mortgage rate of 13.75 percent, GAO estimates that revenue bond financing reduces interest rates by approximately 2½ percent.

III. Credit market effects of mortgage revenue bonds

The high volume of mortgage revenue bonds adversely affects the cost of other municipal borrowing.

NAHR'S RESPONSE

The affordability of homeownership for households earning $23,500 per year is significant. In contrast, the median income of homebuyers who received conventional loans in 1981 was $39.196.

In comparison, the average purchase price of a new and existing home was $83,900 and $80,500, respectively in 1982.

Given the average income of $23,000 for mortgage revenue bond recipients found by GAO, along with the average 1982 conventional mortgage interest rate of 16.2 percent, such a family could afford only a $36,000 mortgage. However, there was very little decent housing available for less than $40,000 last year.

The cost methodology employed by GAO overstates the cost of mortgage revenue bonds because it incorrectly assumes that every dollar invested in tax-exempt bonds displaces a dollar of investment in taxable corporate bonds. The loss to the Treasury Department has been calculated by public finance experts to be about one-third the GAO estimate.

Given the appropriate 1982 state agency average mortgage rate of less than 12½ percent, revenue bonds provided nearly a 4 percent reduction in interest rates. Thus, mortgage revenue bonds provide considerably more interest subsidy than assumed by GAO.

GAO not only overestimates the 1982 volume of single family mortgage bonds by almost $2 billion, but the assumed credit market effects do not reflect reality. Despite the development of mortgage revenue bonds in the early 1970's the spread between taxable and tax-exempt bonds is currently the same as it was 20 years ago.

Mr. RANGEL. Thank you.

Mr. Duncan.

Mr. DUNCAN. I don't have any questions at present. I want to thank you very much for your appearance. I might have some questions maybe I could present to you in writing later.

Mr. RANGEL. We should do that for all the members to leave the record open for any written questions.

Mr. DUNCAN. Thank you very much, Mr. Chairman.

Mr. RANGEL. I want to thank both of you for making your contribution to the full committee. As indicated, your full statements will be in the record.

Thank you.

Mr. ARBIB. Thank you, Mr. Chairman.

Mr. DAVIS. Our pleasure, Mr. Rangel. Thank you.

Mr. RANGEL. The committee stands adjourned.

[Whereupon, at 11:51 p.m., the hearing was adjourned.]

[The following was submitted for the record:]

STATEMENT OF THE AIR TRANSPORT ASSOCIATION OF AMERICA

The Air Transport Association of America, on behalf of its member airlines, welcomes the opportunity to provide comments on the recently-created problems affecting the use of industrial development bonds to finance the development of airports in the United States.

Airports have traditionally been financed by state and local governments through the use of industrial developments bonds (IDBs). The IDBs are usually issued pledging the revenues that will be received by the airport from rents, landing fees and other user charges paid by airlines and other tenants for the use of the airport. These bonds are issued under a provision in the Internal Revenue Code (specifically Section 103(b)(2)) which provides that the interest on bonds issued by government authority for the purposes of airport development is exempt from taxation. Treasury has issued regulations which require airports to "serve or be available on a regular basis for general public use or be part of a facility so used."

However, with the enactment of the TEFRA requirement for public approval, a complication has arisen that has hindered the needed expansion of airports. Under the current law, there is a requirement that, in order for an industrial development bond to be tax-exempt, the obligation has to be approved by the governmental unit that issues the obligation and the governmental unit having jurisdiction over the area in which the new facility is located. In the case of airports, this involves a number of governmental units since many of the large municipal airports are located wholly or partially outside the boundaries of the governmental unit which owns and/or operates the airport. In fact, in some cases the airport is within the boundaries of several governmental units.

One such case involving the requirement for multiple jurisdictional approval is an airport owned by a major U.S. city which is located outside the boundaries of that city. The airport operator (city) needs to construct an additional runway which would be on property currently owned by the airport but located in jurisdictions outside of the city. In order to issue the tax exempt bonds for this facility, approval is needed from the other governmental units. The law requires that the governmental unit having jurisdiction over the area in which the facility financed with the bonds is to be located must grant approval. The law does not specifically define the term jurisdiction. A reasonable interpretation would be that, if under state law or charter a governmental unit is authorized to own and operate an airport outside of its geographic boundary, it would have jurisdiction within the meaning of the Code.

Airlines suggest that Section 103(k)(2)(A)(ii) of the Internal Revenue Code be amended by adding a provision which would indicate that, in the case of a public airport, if the governmental unit issuing the obligation is the owner or operator of such airport, that governmental unit be deemed the only governmental unit having jurisdiction for the purposes of the subsection (k).

Member airlines of the Air Transport Association hope that the growth and development of the airports of the United States is not hampered due to the inability of governmental units to receive appropriate financing using industrial development bonds and ask the Committee to clarify the intent of the public approval requirement by appropriate amendment.

STATEMENT OF ALBERT McDONALD, ALABAMA COMMISSIONER OF AGRICULTURE AND INDUSTRIES, AND CHAIRMAN, ALABAMA AGRICULTURAL DEVELOPMENT AUTHORITY

Mr. Chairman, the undersigned as Commissioner of Agriculture and Industries of the State of Alabama, on behalf of the citizens of Alabama and especially its farmers and farm related workers, wishes to go on record before your Committee as being opposed to H.R. 1635, which, in part, attempts to deny the use of FDIC insurance in connection with the issuance of tax free bonds. The reasons for the oppostion follow:

At the offset, this Committee does not have to be told that the farmers throughout the Nation today, due to high interest rates and low prices for the products produced on the farm, are in serious trouble.

One of the few ways that individual states can help these farmers is to make money available to them at an interest rate that does not eat up their profit; and in fact many states, to include Alabama, have attempted to do this. This is generally accomplished by having some state agency or public corporation, as in Alabama, issue tax exempt bonds whereas the bond proceeds can only be used by farmers in furtherance of farming. The use of the funds by farmers, along with helping them out of a dilemma, fosters economic development throughout the State by expanding the tax base and creating new jobs.

To be able to obtain monies that can be loaned to farmers at lower rates than they can obtain from commercial banks, the bonds have to be sold as tax exempt and be rated with a rating sufficiently high enough so the bonds can be sold at a low interest rate. If the bonds were not tax exempt and did not have some type of official guarantee, then they would be rated so high and sold at such a high rate of interest that it would be impossible to lend this money to farmers at any type of savings on interest.

One method recently devised is to have FDIC, in effect, do nothing more than what it already has an obligation to do. This involvement is to have the bond purchaser only purchase up to $100,000 in bonds. The bond issuing and lending authority then purchase certificates of deposit from the lending banks. They in turn are obligated to extend to a qualified farmer the monies that are used to purchase the C.D. at this low interest rate for farm purposes.

As is readily obvious, the role of FDIC in this matter is only to insure that if the lending bank folds, then FDIC would be obligated, as it already is, to guarantee any certificates of deposit up to $100,000. There is no more drain upon the U.S. Treasure from this procedure than if it didn't exist. Certificates of deposit are by law today protected by FDIC up to $100,000.

Section 2 of H.R. 1635 apparently attempts to prohibit the investment of tax exempt funds in federally insured deposits, or in effect, shut down a legitimate attempt by Alabama and several other states to get low interest money in the hands of farmers. If this bill passes, then another avenue which attempts to keep America's farmers from either leaving the farm or going bankrupt will be closed. This does not begin to take into account the side effects of this money in the fostering of economic development throughout the State and the creation of new jobs.

It is not known how much more America's farmers can endure before the entire Nation and its population feels this impact but it is not believed that we need to find out. Therefore, the attempt which Alabama and many other states are using to get low interest money into the hands of farmers, which creates no drain upon the U.S. Treasure should not be struck down by the passage of H.R. 1635.

Due to the above, speaking on behalf of the Alabama Agricultural Development Authority, and the entire population of Alabama, and especially its farmers, I urge your Committee not to take favorable action on H.R. 1635.

Statement of Hon. Bill Sheffield, Governor, State of Alaska

The Alaska Industrial Development Authority and the State of Alaska oppose H.R. 1635, which would essentially eliminate industrial development bond financing. After almost two years of congressional consideration, the Tax Equity and Fiscal Responsibility Act (TEFRA) in 1982 proposed limitations and restrictions on the issuance of industrial development bonds. No further changes should be made in the law until the impact of these changes becomes clear.

Industrial development bonds are an important tool to improve productivity and modernize plant and equipment. IDB financing in the last several years has provided in many cases the only source of financing at reasonable interest rates for business purposes. It is not now the time to deprive state and local governments of this important tool available to stimulate economic development during the period when the economy is climbing out of recession—especially not when IDBs created or saved 2,384 jobs in Alaska in Calendar Year 1982.

H.R. 1635 would eliminate large companies from the use of small issue industrial development bonds. Large companies are defined as companies with over $20,000,000 world-wide capital expendistures over three years previous to the issuance of the bonds. These rules were originally suggested almost one and one-half years ago in the Treasury's proposal for the 1982 tax legislation.

The exclusion of large companies from the benefits of industrial development bond financing would be very detrimental to a natural resource state like Alaska. Alaska expects its natural resources to be developed by the very few large scale industrial mining and manufacturing enterprises with the necessary capital to operate in remove areas far from markets. Resource development projects such as the lead-zinc mining project programmed for the far north region of the state will require every incentive ot make them commercially feasible. The extensive port project necessary may be financable on a tax exempt basis but would not be if a $20,000,000 world-wide capital expenditure limitation were imposed.

In Alaska the small issue industrial development bond program is very important and heavily relied on to provide financing for a variety of business purposes. The state program is managed by the Alaska Industrial Development Authority, or

AIDA, which consists of three cabinet heads, namely, the Commissioner of Commerce and Economic Development; the Commissioner of Revenue; and the Commissioner of Community and Regional Affairs, as well as two public member appointed by the Governor.

The state has made a very heavy commitment of resources for enhancement of industrial development in the state through the appropriation to the Authority of $166,000,000 in state-held loans in 1980 and subsequent cash contributions of $23,000,000. These state contribution of assets to the Authority reflects Alaska's determination that industrial development financing is essential to the economic health of the state.

Besides the $20,000,000 world-wide capital expenditure limitation which H.R. 1635 would impose, the bill requires that businesses using tax-exempt financing forego the use of the accelerated cost of recovery system for depreciation deductions. This penalty is so stiff that Congress would in effect be undoing the financial incentive for economic development which the IDB provisions of the Code were intended to create in the first place. The proposal would severely weaken economic development efforts throughout the country and impact specifically and drastically on AIDA's industrial development bond financing programs. The most widely used program of AIDA is the unbrella bond program which has provided industrial development bond financing for 231 projects since the inception of the Authority. Projects financed have included numerous commerical projects such as office or merchandising facility, warehousing and like projects, as well as North Slope energy facilities and fishing boats.

This financing tool has been vital in providing essential facilities in the energy development of the state and in the modernization of its essential renewable resource fishing industry.

Economic diversification and the building of our infrastructure is a top riority for the state. H.R. 1635 will destroy the ability of the state to finance stand alone or supported industrial projects for which it has made a substantial commitment of resources. The Alaska industrial Development Authority has a vital role to play in the building of the economic infrastructure of the state and elsewhere throughout the United States. Now is certainly not the time to eliminate this successful economic development tool.

STATEMENT OF ROBERT R. GREEN, CHAIRMAN, PORT FINANCE COMMITTEE, AND J. RON BRINSON, PRESIDENT, AMERICAN ASSOCIATION OF PORT AUTHORITIES

Tax-exempt bond financing is a vital concern of the U.S. port industry. As the industry's spokesman, the American Association of Port Authorities has a particular interest in H.R. 1635 and other legislation relating to tax-exempt financing. Founded in 1912 and headquartered in Washington, D.C., AAPA represents public port agencies throughout the Western Hemisphere, including all major ports of the United States. The finance issue is of paramount interest not only to our ports and shippers, but indeed, to our nation as well.

The national seaport system of the United States consists of 189 deepdraft ports located on the Atlantic, Gulf and Pacific coasts as well as the Great Lakes. Annual throughput of these ports is well in excess of a billion tons, including cargoes moving in the foreign, Great Lakes, coastwise and domestic ocean trades of the United States. Foreign trade alone comprises nearly a quarter of U.S. Gross National Product. More than 98 percent of U.S. overseas foreign commerce by volume and approximately two-thirds of it by value is carried in deepdraft oceangoing vessels, and is dependent, therefore, on the facilities and services provided by our ports. At the same time, the port industry pumps billions of dollars into the national economy and directly and indirectly, provides more than a million jobs. Our ports also have a key role in the nation's defense.

None of this would be possible were it not for the billions of dollars ($5 billion for the 1946–1980 period alone) in non-federal monies invested in new and improved cargo-handling facilities at our ports. At least $5 billion more will be required, according to the Maritime Administration, in this decade alone to accommodate the anticipated growth of U.S. ocean and Great Lakes traffic. The initiative in every instance has and will come not from the federal government, but from local and state port authorities and the private sector.

Port authorities were established to take over terminal operations when it became clear that private enterprise could no longer afford to do the job on its own. Port authorities are publicly-owned entities chartered by state and local governments and charged with the responsibility of developing and mainting to maximum public advantage, the natural resources afforded by deepwater channels and harbors. What needs emphasizing here is that these authorities are public bodies mandated by law to serve a public purpose.

In its consideration of these bills and the tax needs of this nation, we ask the Committee to take into full account the problems of financing port facilities. While agreeing in principle to the need for eliminating abuses of the present system, we feel that the legislation, as reported, reaches too far—that it would punish the innocent as well as the guilty, that to some extent it reaches into areas where no evidence of abuse has been documented.

Turning to specifics, H.R. 1176 would repeal the sunset provision of the Mortgage Subsidy Bond Tax Act of 1980. No port authority that we know of has issued tax-exempt mortgage revenue bonds. For that reason, we are in no position to make recommendations or, indeed, to in any way substitute our judgement for that of the Committee. If tax-exempt mortgage bonds are in fact beneficial to the nation, then their continued issuance should be permitted. Otherwise the sunset provision should be left undisturbed.

One area of alleged abuse is the use of Federal Savings and Loan Insurance Corporation and Federal Deposit Insurance Corporation deposit insurance to back tax-exempt bonds. Historically, tax-exempt obligations have not been backed by federal guarantees. This, we agree, is an abuse and should be discontinued. Accordingly, on this point, we support H.R. 1635.

H.R. 1635 would place additional restrictions on so-called "small issue" industrial development bonds (IDB). Many ports directly or through affiliated industrial development corporations, have been involved in the issuance of securities of this type. While AAPA has taken no specific position on this matter, we do recognize that small issue IDBs, housing bonds and other new forms of tax-exempt financing have become major competitors in the same market where our traditional industrial development bonds and general obligation bonds are sold. As more tax-exempt paper goes into the market, the greater the competition for the investor's dollar and the higher interest rates are likely to go.

We recognize that the small issue privilege has been abused in some instances. Most certainly such abuses of Congressional intent should not be permitted to continue. Some believe that changes made by TEFRA have in fact reduced the volume of small issue revenue bonds while correcting the abuses as well. Here again, we are in no position to make a judgement. Where abuses if any remain, we would support the Committee's efforts to eliminate them.

Our principal concern is that H.R. 1635 is also targeted to areas and activities where there has been no abuse of the law or of Congressional intent. To our knowledge, no port authority has been accused or alleged to have misused its authority in the issuance of tax-exempt bonds to finance the building of wharves, docks and related storage facilities. Possibly two of the largest issues of tax-exempt bonds for port purposes were those used to finance crude oil terminals at Valdez, Alaska and LOOP—the Louisiana Offshore Oil Port. The Valdez terminals are used for the transshipment of North Slope crude to the "lower" 48 states. The LOOP facility permits the unloading of supertankers carrying oil from the Middle East and the North Sea—vessels too large to be accommodated at any U.S. coastal port. Both facilities serve the critical energy needs of the United States, benefit the public at large and are vital to the nation's security. Container terminals and facilities for the export of grain and coal, both essential to this nation's balance of trade, have been developed at other ports on every coast. Most of these facilities are now being financed through tax-exempt industrial bonds as provided in Section 103(B)(4)(D).

Because of their enormous cost, most require a long-term commitment from the lessor to insure financing. In some if not most instances, general revenues of the port authority constructing the facility may not be sufficient to enable its use of general revenue bonds to raise the needed capital. In these circumstances, a long-term contract is entered into with the lessor agreeing to pay principal and interest on the bonds as well as other port charges such as ground rent, dockage, etc. So doing enables the port authority to issue bonds to finance the facility, backed by the credit of the lessor and with the knowledge that the lessor will pay the principal and interest in addition to these other port charges. In return, the lessor may receive minimal present value tax benefits which basically include the right to depreciate his use of the facility using the ACRS life.

We do not believe that this constitutes an abuse of the right to issue tax-exempt debt. We believe that these bonds serve a public purpose by facilitating the construction of the physical plant needed to ensure the continued growth of American exports. Nor do we feel that use of taxexempt financing in the manner outlined above constitutes something new or unusual. In fact, it is a method of financing port facilities long in use.

These are trying times for our ports, inland waterway users and others involved in water resource development. The cost sharing, cost recovery and user charge issues that will have a serious financial impact on our industry have yet to be resolved by Congress and the Administration. For almost 160 years, the federal government has borne the full burden of navigation costs. Now it proposes transferring a substantial share of that burden to local interests, meaning in effect, the local port authorities. Also being bandied about are user charges for Coast Guard and Customs' services. Present economic conditions and pressures to lower taxes have severely limited the port industry's ability to issue general obligation bonds. More restrictive conditions coming on top of these additional costs, actual and proposed, would seriously hamper if not cripple the port industry's ability to finance the improvements so vital to our nation's growth and security. Indeed we face much the same dilemma Congress does in trying to provide essential servcies at the lowest possible cost. We submit that the record will produce no justification for extending the cost recovery period for docks, wharves and related storage facilities financed with tax-exempt bonds.

In summary, we believe that the port authorities are doing the job they were created to do; that they are doing it very efficiently and in a manner that benefits both the localities they serve and the nation as a whole; and that in doing so, they have not abused the tax-exempt debt priviledge. In short, please don't punish the ports for what others may have done. Find the guilty parties and stop them. Thank you.

AMERICAN ASSOCIATION OF RETIRED PERSONS,
Washington, D.C., June 21, 1983.

Mr. JOHN J. SALMON,
Chief Counsel, Committee on Ways and Means, Washington, D.C.

DEAR MR. SALMON: The American Association of Retired Persons would like to submit the following statement to be included in the record of the hearing on "Trends in Municipal Financing and the Use of Tax-Exempt Bonds to Finance Private Activities" that was held June 14 by the Committee.

The Association has a general concern that Congress carefully scrutinze tax expenditures, because the current massive federal deficit makes many of them unaffordable. AARP also has a more specific concern that one such expenditure which funds private activity, the tax-exempt bond used to finance hospital construction, actually leads to unnecessary increases in hospital capacity and therefore increased hospital costs.

AARP believes that it is inappropriate to encourage new hospital construction by this open-ended tax expenditure when the excess of hospital beds is one of the factors contributing to rapidly rising costs of medical care that are, in turn, threatening the financial solvency of the Medicare program. While hospital construction and tax-free financing may be needed in certain locations, no such showing of need is required to receive the benefit of the tax-exempt bond. As a result, the tax expenditure is allocated in an extremely inefficient manner.

Despite a general excess capacity of hospital beds, tax-exempt financing for private nonprofit hospitals is becoming increasingly prevalent. According to the Congressional Budget Office, the volume of these bonds issued nearly doubled from 1981 to 1982, rising from $3,8 billion to $6.9 billion.

The Association feels that the use of tax-exempt financing for hospitals should be carefully reviewed by the Committee. As a means of allocating resources efficiently and controlling the growth of hospital costs, the tax expenditure should only be available in cases in which additional capacity is shown to be needed.

Sincerely,

PETER W. HUGHES,
Legislative Counsel.

AMERICAN BANKERS ASSOCIATION,
Washington, D.C., June 17, 1983.

Mr. JOHN J. SALMON,
Chief Counsel, Committee on Ways and Means, Washington, D.C.

DEAR MR. SALMON: Attached is a report submitted by a special task force of the American Bankers Association which reflects the Association's views relative to the issue of industrial development bonds. While we adopted this position during 1982 when other proposals were pending, it does relate to the issues arising from H.R. 1635.

Additionally, I have included a paper outlining our position relative to obligations directly or indirectly graranteed or insured by FDIC or FSLIC deposit insurance.

We respectfully request both statements submitted be included in the record.

Sincerely,

GERALD M. LOWRIE.

INDUSTRIAL DEVELOPMENT BONDS—RECOMMENDATIONS

A Task Force on Industrial Development (IDBs) was appointed by the Chairman of the ABA's Government Relations Council at the Council's Spring Meeting. Its assignment is to recommend for adoption by the Council position on the use of tax-exempt bonds for private purposes.

The members of the Task Force chaired by Jack Davis are Keen Addington, Dale DeKoster, Tom Milliken and Bill Rodgers. The following recommendations were agreed to by a majority vote and it was further agreed that any member of the Task Force may submit a minority view on any items or proposals to which he disagrees.

RECOMMENDATION

It is generally agreed by the members of the ABA's Task Force on IDBs that the concept of tax-exempt bonds for private purposes has progressed far beyond what was originally intended. The growning use of IDBs for industrial, retailing and commerical development has drawn much attention and increasing controversy over the misuse and abuse of their issuance. The Task Force felt that the unlimited, unrestricted and unwarranted use of such financing for nontraditional public purposes has had a disruptive effect on the entire municipal securities market and has driven up the cost that municipalities must pay on tax-exempt bonds for more traditional purposes.

The Task Force recommends that the ABA support limitation on IDBs that would result in their better use. In this regard, the limitations should apply to all types of IDBs except where it is inappropriate.

Specifically the Task Force recommends support of proposals that:

1. Require small issue IDBs be limited to businesses with capital expenditures of less than $20 million over a six-year period and no more than $10 million of IDBs outstanding immediately after the issue,
2. Deny accelerated cost recovery depreciation if IDBs are used,
3. Require elected municipal officers to approve issuance of IDBs, and,
4. Require municipalities to report issuance of IDBs to the IRS.

The Task Force recommends opposition to proposals that:

1. Result in the total abolishment of IDBs,
2. Require the governmental unit to contribute to the facility financed,
3. Require registration of IDBs, or,
4. Require a special meeting for the sole purpose of approving the bonds prior to their issuance.

We believe that this recommended policy generally is an appropriate and reasonable response to the problems of the IDB financing without destroying its usefulness. We recognize that the various 'proposals before Congress and ones that may be suggested in the future may not fit these recommendations, but with a little flexibility ABA should find itself able to support a positive measure that falls within the parameters of our policy if these recommendations are adopted.

STATEMENT OF THE AMERICAN BANKERS ASSOCIATION

The American Bankers Association is pleased to provide this statement regarding H.R. 1635, a bill which would deny tax exemption to bonds if proceeds are invested in federally insured deposits. Our Association consists of approximately 90 percent of the more than 14,000 full service banks in the U.S.

In several recent issues of tax-exempt Industrial Development Revenue Bonds (IRBs), the issuing authority has deposited the bond proceeds in a bank or savings and loan account insured by the FDIC or FSLIC to be loaned to the user by the depository institution. In the typical arrangement, the issuer transfers the proceeds to a trustee for the bondholders and the trustee deposits the funds in FDIC or FSLIC insured certificates of deposit (CDs). The depository institution agrees to make the deposited funds available to private users for stated tax-exempt purposes. Interest and principal on the bonds are repaid from payments on the CDs. The repayment of the bonds is secured by the CD. Because the proceeds of the bonds are used ultimately for exempt purposes, the bonds qualify as tax-exempt obligations under present law. Because the trustee for the bondholder holds a CD in an insured institution the amount of each bondholder's holding is insured to the extent of $100,000 for each depository institution.

Our Association opposes this use of federal insurance to, in essence, transform a tax-exempt issue into one which is insured by the depository insurance of the United States government, therefore, we support H.R. 1635, including its effective date of April 15, 1983, We feel that this is an inappropriate use of the depository insurance funds and certainly was not the purpose for which they were created.

A tax-exempt federally guaranteed bond, which may be perceived as superior in the market and in direct competition with those obligations issued directly by the Federal government, may well increase the borrowing costs of Federal, state and local governments. As the current cost of funding the debt exceeds $100 million annually, we would have strong reservations about any scheme which would exacerate that figure.

Even though many savings and loans and some commercial banks have gained sizeable deposits as a result of this "loan to lender" program. it is the opinion of our Association that this legislation is in the best interest of the country and that the April 15, 1983 effective date must be maintained.

American Consulting Engineers Council,
Washington, D.C., June 16, 1983.

Hon. Dan Rostenkowski,
Chairman, Committee on Ways and Means,
U.S. House of Representatives, Washington, D.C.

Dear Chairman Rostenkowski: The American Consulting Engineers Council (ACEC) is pleased to provide these comments on H.R. 1635, the "Industrial Development Bond Limitation Act of 1983", and H.R. 1176, the "Housing Finance Opportunity Act of 1983", for the printed hearing record.

BACKGROUND

ACEC is an organization of over 3,800 consulting engineering firms with nearly 120,000 employees, located and practicing in all 50 states. A majority of our firms are involved in providing engineering services to federal and state agencies, municipalities and special-purpose districts, including planning and design of public utilities as well as buildings and other facilities.

As we noted in previous comments to your Committee on H.R. 3110, the "Governmental Leasing Tax Act of 1983", most state and local government units are turning to "innovative", tax-based approaches to financing new construction, repair and renewal of essential pubic capital facilities in order to cope with the "triple threat" of facilities deterioration, diminished direct federal participation and publicly-imposed constraints on state and local taxing authority. From our perspective, this is not an undesirable development, and we urge the Committee to fully and fairly evaluate the costs and benefits of this increase in popularity of tax-based financing.

At the same time, we recognize and accept the premise that such incentives ought to be generally limited to essential public purposes and we welcome the Committee's attention to this aspect of industrial development and mortgage subsidy bond financing.

SUMMARY OF POSITION

With this background, we recommend that, in consideration of H.R. 1635, no specific restrictions beyond those imposed by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) on the issue of industrial development bonds be legislated at this time except that the Committee consider (1) limiting the issuance of "private activity" bonds based on state-by-state volumes of public bond issues; and (2) prohibiting IDB financing for bonds guaranteed directly or indirectly by the FDIC or FSLIC.

With respect to H.R. 1176, we believe that the December 31, 1983, "sunset" on tax exemptions for mortgage subsidy bonds should not be repealed.

SPECIFIC COMMENTS ON H.R. 1635

Use of industrial development bonds (IDBs), publicly-sponsored obligations used to fund a variety of business/commercial/industrial purposes, has become increasingly prominent in the efforts of state and local governmental agencies and special districts to spur economic and community development.

Recognizing this trend, the Congress, in passing the Tax and Fiscal Responsibility Act of 1982, placed a number of timely and appropriate restrictions on the issuance of IDBs. Among these were restrictions on the availability of accelerated depreciation and new requirements for public hearings and approvals of IDB issues.

We believe that, generally, these restrictions are proving to be effective and that no new restrictions on uses and purposes are necessary or desirable at this time, except that tax exemption of bonds guaranteed directly by the FDIC or FSLIC should be denied. However, the Committee should explore the feasibility of a state-by-state limitation on "private activity" bonding, based on the total volume of public bond issues, as a means of ensuring a proper balance.

Beyond those changes, we urge the Committee to allow state and local government maximum flexibility in using IDBs as a financing tool. Since TEFRA establishes a "sunset" of December 1, 1986, on tax exemption of IDBs, it would be appropriate and desirable to review the list of eligible purposes for which IDBs can be issued closer to that date, to avoid creating needless instability or uncertainty among state and local governments or the public financing and investment community.

SPECIFIC COMMENTS ON H.R. 1176

While the purpose of tailoring a revenue bond for mortgage financing—providing assistance to firsttime homebuyers, particularly those in low- and moderate-income brackets—is a notable and significant one, it now appears that mortgage subsidy bonds (MSBs) have not fulfilled earlier expectations of providing cost-effective homebuying assistance.

As the General Accounting Office (GAO) noted in its report of April 18, 1983:

"With regard to the overall economic efficiency of mortgage revenue bonds, we found them to be quite costly to the Federal Government when compared to the benefits provided buyers and to the possible costs of alternative subsidy mechanisms which could be employed."

Similar conclusions have been reached by other governmental agencies and private groups.

These findings, coupled with the "hidden cost"—the effect of MSBs in sapping the bonding capacity of state and local government for other essential purposes—leads us to conclude that the MSB "sunset" of December 31, 1983, should not be repealed and that the Committee should explore other proposals, including S. 1051, the "Mortgage Retirement Account Act of 1983", if it is deemed desirable to use federal tax incentives to assist first-time homebuyers.

We hope these views are helpful to you and we appreciate the opportunity to provide them to the Committee. Please do not hesitate to contact us if we can be of further assistance.

Very truly yours,

WILLIAM J. BIRKHOFER,
Director, Governmental Affairs.

STATEMENT OF THE AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS

H.R. 1176 would make permanent the authority for the issuance of tax-exempt, single-family mortgage revenue bonds by states or local governments. Such authority is scheduled to expire at the end of 1983.

It has generally been a long-standing policy of the AFL-CIO to oppose the expansion of tax-exempt financing of all types. Such financing benefits primarily higher income taxpayers who are in higher marginal income tax brackets. It causes a loss of federal revenue, which increases federal debt and interest payments by the federal government that contributes to an increase in total budgetary expenditures. It also causes interest rates on other securities to be raised in the competition for funds. Consequently, the rates on other mortgages and loans are higher than they otherwise would have been, and there is a drag on economic activity.

The AFL-CIO did not oppose the enactment of the present authority in 1981 in order to help meet the large and increasing unmet need for homes. The high rates of interest then being charged on mortgages financed with loan funds on which the interest was taxable made housing unaffordable for almost all families. The AFL-CIO did not, at that time, oppose the authority for the issuance of tax-exempt revenue bonds to finance homes for two years.

At this time, after three years of depressed housing production, there is need to catch up with the unmet demand for homes, even with somewhat lower interest rates in the 12 to 13 percent range that prevails now. The great majority of families, especially those of moderate income, however, still cannot afford to buy a home. For that reason, the AFL-CIO recommends the extension of the authority for an additional two years to expire at the end of 1985.

However, in light of the findings of the recent GAO report, on "The costs of Benefits of Single-Family Mortgage Revenue Bonds, that homebuyers with incomes well above median income levels received loans from the bond proceeds, and that a disproportionate amount of the funds was used for loans to higher income homebuyers, the AFL-CIO would favor statutory income eligibility limitations. Such limitations should be designed to assure that at least half of the bond proceeds are used for loans to buyers with less than the median state income, and that none of the bond proceeds are used for loans to buyers with incomes above 120 percent of the median income.

H.R. 1635 would require that personal or real property financed with industrial development bonds (IDBs) must be recovered using the straight-line method, instead of the Accelerated Cost Recovery System. Since businesses financing property acquisitions with tax-exempt bond issues already receive a decided benefit at the expense of the U.S. Treasury, it is appropriate that they should not also receive the accelerated write-off authorized under the Economic Recovery Tax Act of 1981, so that the Treasury can at least regain some of its much needed revenue.

H.R. 1635 is aimed at preventing an abuse of tax-exemption through issuance of industrial development bonds. If the proceeds of such bonds are deposited in financial institutions, the interest on the funds thus deposited generally is not exempt from income tax. However, if the bond proceeds are to be used for certain tax-exempt purposes, the interest paid on the deposit by the financial institution may be tax exempt. One of the exempt purposes is for acquisition, construction, or improvement of land or depreciable property, if the amount of the bond issue, together with certain related capital expenditures, does not exceed $10 million over a 6-year period.

There has arisen a process whereby the proceeds of such a tax-exempt bond issue are used to purchase federally insured certificates of deposit from depository institutions who agree that the funds will be used to make housing mortgage loans. Each bondholder's bonds thus are indirectly insured for up to $100,000. The interest from the bonds remains tax exempt while the certificates of deposits serve as security for repayment of the bonds. The holder of such bonds, therefore, in effect, has federally insured bonds while, at the same time, receiving tax-exempt interest. Consequently, such bonds provide an investment with a tax-exempt yield, while the principal is being insured by the full faith and credit of the United States behind it in the form of the insured certificate of deposit.

The after-tax yield to the investor is significantly greater than on a taxable bond that would be issued by the U.S. Treasury. The tax-exempt bonds that are in effect federally insured, therefore can compete favorably with Treasury issues. It logically causes the Treasury to have to pay higher rates of interest on its debt obligations. The higher after-tax yield will also cause other security obligations to carry higher interest rates than would otherwise be necessary. Such higher interest rates are a distinct disadvantage to the government of the United States and to the U.S. economy. The practice should be prohibited; and for that purpose, the AFL-CIO endorses S. 1061 and urges its enactment.

It is noted, however, that the proposed provision would be applicable to any obligations issued after April 14, 1983. The Treasury on March 4, 1983 announced its support of an April 15, 1983 effective date, except for bonds issued pursuant to a written commitment that was binding on March 4, 1983. However, there may be instances where IDBs were issued with FDIC or FSLIC indirect or direct insurance after the announced date because the issuer was not aware of the Treasury announcement. Since the prohibition is not yet part of the statute, and it is questionable whether an announcement in the absence of law can have the effect of law, it is recommended that any issuances of indirectly or directly Federally insured IDBs before enactment of H.R. 1635 should not be illegal where it would result in economic hardship.

STATEMENT OF MARTIN A. WALL, DIRECTOR OF GOVERNMENT RELATIONS, AMERICAN OSTEOPATHIC HOSPITAL ASSOCIATION

INTRODUCTION

It is a pleasure to present to you the views of the American Osteopathic Hospital Association (AOHA) concerning restrictions on the use of tax-exempt bonds by private non-profit hospitals. AOHA Is the national trade association representing the more than 200 osteopathic hospitals in the United States. Our Association Headquarters is in Arlington Heights, Illinois, with offices in Washington, D.C.

TAX-EXEMPT BOND FINANCING AND HOSPITALS

The debate surrounding the use of industrial development bonds (IDBs) to finance private activities is not a new one. Congressional concerns about mounting federal deficits and the "public purpose" that is served through tax-exempt financisng are legitimate. These and other issues were raised in exhaustive discussion a year ago in the context of the Tax Equity and Fiscal Responsibility Act (TEFRA).

While TEFRA placed a number of restrictions on IDBs, it exempted non-profit institutions such as community hospitals from most of the restrictions. However, non-profit hospitals are now required to register bonds with the Internal Revenue Service.

The validity of the arguments accepted by Congress a year ago for maintaining community hospital access to tax-exempt bond financing are even more acute today. Capital financing is the most crucial issue facing community hospitals in the 1980's. This stark reality was confirmed by a study report released last fall by Project Hope. The study, which was both federally and privately funded, concluded that $163 billion will be required this decade merely to finance the modernization of outmoded institutions. Of that amount, 78 percent will be needed merely to maintain, not expand institutions. Especially troubling is the study's conclusion that the industry will fall $54 billion short of its "maintainance" requirement—an outcome that will affect the quality of hospital services rendered.

It is true that use of IDBs now account for about half of hospital financing. However, tax-exempt bonds are the primary source of capitalization left to the community institution. The spurt in utilization is a direct result of the termination of federally supported porograms and the dearth of other capital sources.

Critics of tax-exempt bond financing argue that only a "private purpose" is served by such arrangements and that runs counter to the "public interest." This argument does not reflect the true purposes of hospital tax-exempt financing. Osteopathic hospitals are vital community resources providing a comprehensive range of services to the populations they serve. Half of our institutions are less than 100 beds and many are located in rural, medically underserved areas. It is inaccurate to portray the use of tax-exempt financing by such community oriented facilities as being for "private purposes."

IMPACT ON HOSPITAL COSTS

The argument that the hospital industry's use of tax-exempt bonds leads to increased hospital costs is also flawed. Let's look at the issue from the perspective of a small, 78 bed, non-profit rural osteopathic hospital. Within the past year, this member hospital examined options available to finance necessary construction to meet community needs. The hospital, which sought $5.4 million in sorely needed capital, told us that tax-exempt financing was the sole avenue available if it was to compete in the marketplace and limit increases in its costs. The alternative was to seek conventional financing which, ironically, would have added over $50 per day to each patients bill and ultimately increase costs to the federal government through higher reimbursement. This would also be true under medicare prospective payment since higher interest payments would eventually influence the mechanism through which the system will incorporate capital needs. The result: higher federal spending, increased deficits, and rising health care costs for all.

CONCLUSION

The public and community purposes of tax-exempt bond financing for voluntary hospitals is evident. the paradoxical effect on federal outlays and hospital costs of limiting access is also clear. The 200 community minded osteopathic hospitals urge your Committee not to add further restrictions on the use of tax-exempt bonds by non-profit hospitals.

STATEMENT OF CHARLES D. PHILLIPS, PRESIDENT, AMERICAN PROTESTANT HOSPITAL ASSOCIATION

Mr. Chairman and Members of the Committee: This statement is submitted to the Committee by the American Protestant Hospital Association (APHA) which is comprised of 300 institutions, agencies, and nursing homes across the country and with 2,000 personal members in its division, the College of Chaplains. The APHA has hospitals in 38 States, totalling 60,000 beds. Its institutions range from as small as 17 beds to over 2,000 beds. The APHA hospitals are located in both rural communities and the inner cities, thus serving large proportions of Medicare, Medicaid and charity care patients. Although the APHA hospitals are church-related, they receive little or no direct financial support from the church.

The APHA wishes to emphasize that, in the Committee's deliberations in fine-tuning the availability of tax-exempt bond financing, it carefully consider that non-profit hospitals, whether they be Protestant, Catholic or Jewish, or any other denomination or non-denominational institution, have no other viable alternative to capital financing than through the continued availability of hospital tax-exempt bonds. If non-profit hospitals are to remain economically viable and competitive in the hospital marketplace, they must continue to have access to tax-exempt bonds.

The APHA wishes to identify for this Committee the serious consequences which would flow from any restriction on the availability to non-profit hospitals of tax-exempt bonds.

Any change in the existing law should not have the unintended consequence of limiting access of non-profit hospitals to the capital market. Indeed, there are a number of health care policy reasons which mandate preserving access to tax-exempt financing for such facilities. The APHA, therefore, requests that, if this Committee believes it must amend existing law, it do so only without adversely affecting non profit hospitals' access to tax-exempt bond financing.

It is crucial to maintain the viability of non-profit hospitals because they serve an essential public purpose as acute care health facilities. They also serve the general public as well as the indigent and most have a high Medicare and Medicaid population, particularly in the large inner cities of the country.

These non-profit hospitals face uncertainties because of several factors, including the inadequacies of the Medicare reimbursement system; the newly established Medicare prospective payment system to be implemented on October 1, 1983; the severe limits on the Medicaid program imposed by several States; and the hospitals' high charity caseload.

It would be particularly tragic to the beneficiaries and patients of these hospitals if the hospitals were denied the opportunity to compete for tax-exempt bonds in these days of scarce financial resources.

The harm to the public welfare is highlighted by the fact that often the non-profit hospitals are older Hill-Burton facilities, which we built decades ago and need or will shortly need to renovate or replace their physical plants.[1] If tax-exempt financing is restricted or eliminated and, if, as a result of the unavailability of adequate capital, these hospitals do not survive because their worn out physical plants cannot pass building, fire and life safety codes, what will become of their patients? There simply are not enought public hospitals to absorb and provide adequate care for these patients, who are not being provided health care services by the non-profit institutions.

Clearly, the adverse consequences of denying adequate capital to non-profit hospitals would be far-reaching. These hospitals must be maintained because they are essential public purpose institutions.

Taking as an example Leland Memorial Hospital, in Riverdale, Maryland, which is part of the Adventist Health System, at the present time approximately 30 percent of the patient population is Medicare, 15 percent Medicaid, and 9 percent charity and bad debt. Unquestionably, this hospital serves a proper public purpose. Without access to tax-exempt bonds, it could not renovate or modernize its physical plant or maintain pace with technological advances—which benefit all patients, regardless of who pays for the care.

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[1] For a discussion of the Hill-Burton program, see *Carol* v. *Getts,* "Financial Positioning For Survival," prepared by the Institute for Health Planning, July 1982, at 8–11. Chapter II of this excellent study provides a description of tax-exempt hospital bond financing.

Another example from one of the APHA hospitals is the Evangelical Hospital Association in Oak Brook, Illinois, a suburb of Chicago. Evangelical recently agreed to renovate and operate two hospitals in the city of Chicago. Without tax-exempt bond financing, this undertaking by Evangelical would not be possible. Other noteworthy examples of APHA hospitals using tax-exempt bond financing for inner city hospitals using tax-exempt bond financing for inner city hospitals also may be cited.

From a different perspective the issues are further illuminated considering that the amounts of capital which will be required by hospitals in this decade has been approximated to range from $130 billion to $190 billion.

There are today only two major markets for capital financing. The first is the corporate market for taxable issues with interest rates from 12 percent to 13 percent. The minimum acceptance rating by the standard rating systems is either BAA or BBB; without that, institutions guided by the "prudent man rule" could not purchase offerings below that minimum. Without that rating, a hospital would be faced with interest rates of 15 percent to 16 percent. Second, in the tax-exempt market, the focus of today's hearings, high quality bonds are issued today at about 9 percent. With a three to four point difference in percentage rates between the corporate and tax-exempt markets, the corporate market is approximately 30 percent more expensive and, for most non-profit hospital entities, simply not realistically available to them.

A concern frequently heard is that continuing to make tax-exempt financing available to hospitals reduces revenues to the Department of the Treasury. While there may be fewer taxes collected by the Treasury as a result of tax-exempt bonds, the feared losses of Federal revenue as a result of tax-exempt hospital bonds ignores the fact that tax-exempt hospital financing reduces the cost to the Federal government for Medicare; Medicaid; health benefits of Federal employees; CHAMPUS; and goods and services purchased by the government from the private sector. Tax-exempt bonds, in fact, may even be net revenue producers for the government.[2]

In addition, forcing hospitals into the taxable issues market would not automatically result in a proportionate increase in Federal revenues. For instance, investors in taxable hospital issues, which are themselves tax-exempt, are not taxed on the interest earned on such investments.

There are other costs to society if the tax-exempt bonds avenue were closed. One, simply eliminating this route of financing would not automatically and necessarily mean that Treasury revenues would increase. Some hospitals, certainly in the short run, would simply not obligate capital projects. Accordingly, there would be no increase in Treasury revenues. Two, those few hospitals which would elect the corporate market would necessarily have higher costs which would have to be passed on to private payors and patients. Conversely, tax-exempt financing allows non-profit hospitals to achieve lower costs per patient day. Without the availability of tax-exempt capital financing, many non-profit hospitals would necessarily have to increase charges.[3]

In addition, other problems would be created if hospitals were forced to resort to taxable financing. For instance, the life of the asset as recognized by Medicare is longer than the length of taxable financing. Medicare, nevertheless, reimburses depreciation over the life of the asset as determined by it. The financial viability of hospitals, thus, would be weakened by their having to retire the debt faster than the depreciation schedule recognized by Medicare.

Another possible misperception of tax-exempt bond financing is that such financing invariably leads to new and more hospital beds. This, of course, is not the case.[4] The non-profit hospital requires capital like any other on-going business. Capital is needed not only for beds and facilities but also because of major equipment and replacement and modernizing costs for existing plant.

Most tax-exempt bond financing today by non-profit hospitals is for renovation of physical plant, modernization or capital-equipment purchases. For financing of these types, the time lag is generally one year; when the financing is for new facilities, delays of up to three years are not uncommon. This means that from the time the financial feasibility study commences, through the certificate-of-need (CON) process, bond rating and approval to bond issuance will be from one to three years if there are no hitches at any step along the way. While this is a long process, the tax-exempt bond is integral to the non-profit hospital to remain competitive, to continue making high quality health care available to all patients, regardless of ability to pay, and to keep pace with technological advances.

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[2] "The Uses and Impacts of Hospital Tax-Exempt Financing," Health Care Financing Study Group, May 1982, at 38 (hereinafter cited as Study Group). This monograph provides a thorough, indepth examination of the continued need for tax-exempt hospital bond financing for non-profit hospitals.

[3] *See, e.g.,* Study Group at 37.

[4] *See, e.g.,* Study Group at 38.

As this Committee knows, the President's Private Sector Survey on Cost Control (the Grace Commission), recently recommended that tax-exempt hospital bonds be general obligation issues. While this has surface plausibility, the AHPA would respectfully suggest that this would be an unwise policy to follow and would necessarily lead, if enacted, to foreclosing most, if not all, tax-exempt hospital bonds. Financing the capital needs of community, non-profit hospitals is an integral community function, with an obvious, demonstrated public purpose.

The AHPA would submit, therefore, that restricting or eliminating the availability of tax-exempt bond financing for non-profit hospitals would be a wrongheaded approach. While it is true that there would be immediate short term reductions in the use of such vehicles if restrictions were enacted, in the long term the fact would remain that non-profit hospitals need capital infusions from time to time to remain open, operating and serving the needs of their communities, whether they be urban or rural.[5]

The AHPA believes a wiser, more far-sighted, and direct, approach to controlling health care costs—our common goal—would be to extend, in an amended fashion, the existing health planning program and sunset it automatically on September 30, 1986. For example, direct Federal grants to local community-wide planning organizations and allowing the communities to decide which health projects it and the people wish, may be an appropriate solution. This, we believe, would properly minimize Federal involvement. Any health planning extension legislation should, however, sunset the program by September 30, 1986.

The Committee also should be mindful of the interaction of any activity it may take in tax-exempt bond financing with the recent action of the Congress in establishing a Medicare prospective payment system, beginning on October 1 of this year.

Public Law No. 98-21, the Social Security Amendments of 1983, establishes a new Medicare prospective payment system. Under this salutary endeavor, Medicare cost reimbursement under TEFRA will be phased out over the next three years while the prospective DRG payments will be phased in. Similarly, over the same three-year period, the program will be moving toward a single national urban-rural DRG rate. One of the studies that the Secretary of the Department of health and Human Services is required to report to the Congress on within 18 months is the methodology for including capital-related costs associated with inpatient hospital service in the prospective payment system. Any action by the Congress in the capital-related area, we believe, should be held in abeyance until the Secretary has had an opportunity to report on this matter.

Moreover, the Conference Report, H.R. Report No. 98-47, accompanying the passage of the prospective payment legislation, stated that the "managers believe no assurances can be given that, under a new system of paying for projects obligated . . . after the date of enactment of this legislation (i.e., April 20, 1983) will continue to be paid on a reasonable cost basis." Since hospitals, analsysts and underwriters have already begun to develop and scrutinize long-range plans on the basis of that statement by the managers, and the unknown impact of the DRG payment system, it would be particularly harmful to non-profit hospitals, and certainly to their public beneficiaries and patients, for the Congress to make any changes at this time in the availability of tax-exempt bond financing for non-profit hospitals.

Any change in current law should be thoroughly debated and carefully considered for the widest possible implications for non-profit hospitals, especially in light of their traditional role of continually providing high quality care to entitlement and charity patients.

While recognizing that the proposed legislation being considered in these hearings does not address non-profit hospitals directly, the APHA is aware that many actions of the Congress have unintended consequences. For example, non-profit hospitals, as a result of the changes made in the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, with regard to charitable contributions, have seen dramatic and significant fall-offs in charitable contributions to our hospitals. Many hospitals simply would not be able to survive another blow to their fiscal solvency, even if not intended, if their access to tax-exempt bonds to finance certain capital projects and the purchase of new equipment were foreclosed.

Technological innovation is a hallmark of the American medical system. The patient expects the highest quality medical care at an affordable price in this era of procompetition. Without this availability of tax-exempt financing, the non-profit sector could not remain economically viable and competitive in the hospital marketplace, as the Congress and the Administration move us to a procompetition environment.[6]

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[5] *See, e.g.,* Study Group at 38.

To summarize, the availability of tax-exempt financing for non-profit hospitals must be preserved to maintain the economic viability of non-profit hospitals and to allow them to remain competitive in the hospital marketplace for the following considerations: the essential public purpose served by such hospitals; the compelling need for capital for necessary renovations; the adverse consequences of forcing hospitals to seek taxable financing; and the uncertain impact of Medicare prospective payment on the hospital environment, including the availability of capital.

The APHA is grateful to the Chairman, the other distingished Members of this Committee, and its very capable staff, for this opportunity to present its views on this critical public policy issue.

ASSOCIATED HOSPITAL SYSTEMS,
Phoenix, Ariz., June 15, 1983.

Hon. DAN ROSTENKOWSKI,
Chairman, House Ways and Means Committee
(Attention: John J. Salmon, Chief Counsel).

DEAR MR. CHAIRMAN: On behalf of Associated Hospital Systems, an association of non-profit, multi-institutional health care systems, I would like to submit the following comments for the hearing record on trends in municipal financing and the use of tax-exempt bonds to finance private activities. The members of our association own, lease or manage 164 acute care hospitals with over $2 billion in annual revenues.

We believe that the public benefits which arise from non-profit hospital use of tax-exempt financing to meet capital needs far exceed the costs to the federal government in the form of tax expenditures. It is important in the analysis of this issue to consider several key points—

1. The problem of financing services that are in the public interest for non-profit hospitals to perform, but must be provided at a loss or even without any payment;
2. The accessibility to the present capital markets for non-profit hospitals;
3. Non-profit hospitals' need for capital funds;
4. The facts that Federal grant funds are no longer available, and that the relative value of philanthropy has diminished; and
5. The fact that payments for care by both public and private payers has become more restrictive, limiting cost shifting.

As this Committee knows well, competition to obtain funds in the capital markets is intense. In part the rapid expansion of federal government borrowing and in part the monetary policies of the Federal Reserve, and the significant growth in borrowing for the replacement and modernization of our public service infrastructure have all heightened the competiton for capital and increased the cost of capital. Non-profit hospitals generally do not have the high profit margins that would make them triple A risks and give them the lowest credit costs. Borrowing for them is comparatively expensive.

A large number of the hospitals in the country today were constructed in the post-World War II period through the assistance of the Hill-Burton program. Many of these buildings are approaching the end of their useful life and are in need of renovation and modernization. In addition, the changing demographic patterns and the growth areas of the country give rise to the need to expand or develop new delivery capacity for institutional health services. It has been estimated by ICF, Inc. that capital needs of hospitals in the remainder of this decade will exceed $150 billion.

For non-profit hospitals there are limited opportunities to accumulate capital. Historically government grants and loans and philanthropic contributions played a significant role in capital formation for non-profit hospitals. Government grants are virtually not available now and philanthropy has declined due to, among other reasons, changed tax policies and the intervention of government as a purchaser of care for the elderly and the poor. The overall financial position, particularly with respect to capital formation, of many non-profit hospitals has greatly deteriorated. This is partly as a result of the failure of governmental programs to recognize fully the need for added capital and non-profit hospital commitments to the provision of services that are in public interest but which may not be financially viable. The opportunity for internal generation of funds from profits is generally very limited for non-profit facilities.

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[6] *See, e.g.,* Study Group at 38.

More and more non-profit hospitals are dependent on the debt capital markets for the greater part of their capital needs. The use of tax-exempt financing instruments by non-profit hospitals accounts for well over half of the capital consumed by this segment of the delivery system. It is particularly important to many non-profit hospitals which, if they had to raise capital through taxable instruments, would have to pay higher interest costs because of their deteriorated financial condition. In many instances these institutions would simply be frozen out of the debt capital market because they could not pay the higher capital costs.

There are some important facts about the role and mission of non-profit hospitals which distinguish them from other institutional providers. In many cases these are the institutions with broad commitments to community services regardless of their profitability. In addition to serving large numbers of publicly financed patients (Medicare and Medicaid), often at discounted rates, these institutions provide large amounts of uncompensated care. Moreover, these same institutions frequently provide the locus for educational programs and a variety of community outreach activities which are not financially self-supporting. They are in many cases located in areas where the poor reside and are treated. As a rule, profit motivated organizations do not compete for the right to serve in these localities.

For these and other reasons non-profit hospitals need access to affordable capital sources. Without such access many of these organizations will be unable to survive and continue their commitment to a variety of community needs. Without sufficient capital in the non-profit sector the character and structure of the hospital delivery system will be fundamentally altered. It is important to note that the new prospective payment system and new competitive pressures are already placing stress on non-profit hospitals and their services.

In such a new environment it is not possible to predict what community services will be maintained, but it is certainly likely that those activities which cannot support themselves will be in great jeopardy. The government cannot allow access to care for the poor to be closed out. It is better to provide fair access to capital for such institutions, than to force them into a financial crisis making it necessary to mount an emergency rescue operation.

From the federal tax policy perspective, the revenue gained from elimination of non-profit hospital access to tax-exempt financing must be weighed against both the higher costs of services which arises from higher capital costs and the higher social costs arising from the deterioration and loss of a range of community services which may be terminated. It makes no sense in a time of high unemployment and cuts in health spending to hamper the ability of voluntary institutions to offer necessary care to those unable to pay. The cost of these losses will certainly be seen in other sectors where the decline in health status of many of our citizens generates new costs and adversely affects the productivity of our economy.

In contrast, the cost to the federal treasury in the form of foregone revenues is relatively modest. In fact, Medicare and Medicaid expenditures for capital costs are reduced by non-profit hospital use of tax-exempt financing. Further, it does not seem to be an equitable public policy to adopt a position which, in effect, discriminates against the future viability of the non-profit hospital sector. For surely, if non-profits are not competitive many more of them will eventually be assimilated by other organizational types or driven out business altogether. They will be noncompetitive because of the costs of their unprofitable services, the higher costs of capital they will have to pay, and because the government and private sources no longer provide them the necessary financial aid. We do not believe the Congress wishes to eliminate or significantly diminish the role of non-profit hospitals in the delivery of health services.

Therefore, we urge this Committee to examine carefully the consequences of reducing or eliminating non-profit hospital access to tax exempt financing instruments. We strongly recommend that this source of financing hospital capital needs be preserved. At issue here is not the question of overcapitalization—payment reforms and planning regulation play a key and determining role in the type and location of hospital capital investment. The central issue is the maintenance of an economical method of meeting the legitimate capital needs of our nation's non-profit hospitals.

We ask for your favorable consideration of these recommendations, and we are anxious to provide additional information you may require in reviewing this matter.

Sincerely,

MERLIN K. DUVAL, M.D.
President.

ASSOCIATION OF AMERICAN MEDICAL COLLEGES,
Washington, D.C., June 15, 1983.

Hon. DAN ROSTENKOWSKI,
Chairman, Ways and Means Committee, Washington, D.C.

DEAR MR. CHAIRMAN: The Association of American Medical Colleges (AAMC) wishes to take this opportunity to convey its views on "the use of tax-exempt bonds to finance private activities" and requests that this correspondence be included in the hearing record. The Association's constituency includes all of the nation's medical schools, 74 academic societies, and more than 325 non-federal, not-for-profit teaching hospitals. With philanthropy and government grants for capital projects continuing to wane, these educational and health care entities have come to rely heavily on the availability of tax-exempt financing. Therefore, any discussion that could impact its continued availability to these public purpose institutions is of direct and vital interest to the AAMC, its members, and the communities and publics they serve.

Last year, in adoption of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), the Congress considered proposals that would have severely restricted the use of tax-exempt bonds by nonprofit 501(c)(3) organizations such as hospitals and academic facilities. After extensive review and debate, the Congress recognized that these private entities use tax-exempt bonds for public purposes and specifically exempted them from any major restrictions on the availability of such financing. We urge you to stand by this wise determination in your current deliberations on this issue, for the rationale supporing it remains unchanged. These reasons merit brief reiteration:

(1) Tax-exempt revenue bonds issued to finance education and hospital facility construction and student loans support nonprofit activities with the express purpose of creating a healthier and better educated public. Benefits do not go to stockholders, they are directed to the community and the nation-at-large.

(2) The traditional sources of capital for private, nonprofit hospitals and academic centers—earnings accumulation, charitable contributions and debt—have been impaired by a variety of federal government actions and the general state of the economy. Moveover, these nonprofit institutions lack access to other forms of capital and financial arrangements utilized by investor-owned organizations. Therefore, tax-exempt financing is an appropriate and effective form of federal assistance to private, nonprofit schools and hospitals in meeting their unique problems in raising needed capital and averting the erosion of quality care and education.

(3) The use of tax-exempt bond revenue at nonprofit hospitals, colleges and universities amounts of less than 14 percent of all long-term tax-exempt issues and results in a federal tax revenue loss that is miniscule. Furthermore, the lower interest expenses of tax-exempt financed hospitals contributes to reduced Medicare and Medicaid reimbursement outlays.

(4) There is no evidence linking private, nonprofit hospitals and educational institutions to misuse of tax-exempt financing. In fact, the vast majority of hospital construction projects specifically are undertaken to replace or renovate antiquated, inefficient and substandard facilities and equipment, or to convert existing facilities in response to evolving medical practice and patient demand patterns. In addition, governmental and marketplace mechanisms exist to monitor the need for proposed hospital capital expenditures.

I appreciate this opportunity to express again these critical points about the availability of tax-exempt financing for private, nonprofit hospitals and educational institutions. It is our sincerest hope that this need will continue to be respected within Congress. The AAMC stands ready to discuss this matter with you further at any time.

Sincerely,

JOHN A. D. COOPER, M.D.
President.

STATEMENT OF JOHN C. WEISS III, SENIOR VICE PRESIDENT-FINANCE, BALTIMORE ECONOMIC DEVELOPMENT CORP.

My testimony against HR 1635 shall be brief. Specifically, our view is that no further industrial development bond restrictions ought to be considered this year in view of the substantial restrictions imposed last year. The City of Baltimore, for whom we are the economic development arm, endorses continued use of IDB's because they have expanded the tax base, have created permanent jobs, and have had no adverse effect on the municipal bond market. We firmly believe that the use of industrial development bonds is a vital means for fostering economic development and job creation. The easy access to IDB's is compatible with the Administration's goal of improving private sector employment opportunities through capital formation. And, the changes made by TEFRA have reduced both the abuses and supply of IDB's to the point that further restrictions are not necessary and would be counterproductive.

This bill, in addition to hampering initiatives at the State level such as the Maryland Industrial Development Financing Authority (MIDFA)—an issuer of tax-exempt umbrella bonds and an insurer of IDB's, creates substantial disincentives to industrial concerns for investment and expansion in urban areas such as Baltimore. The combination of extended recovery periods utilizing straight-line depreciation and an artificially low capital expenditure limitation hampers our outreach and development efforts targeted at industry. Not only do these provisions create obstacles for local and regional firms to expand in the City, they clearly thwart the City of Baltimore's and the State of Maryland's activities in bringing East Coast facilities of national companies to Baltimore.

It is important to note that Baltimore's historical approach towards the utilization of tax-exempt private purpose bonds (IDB's) has been one of extreme scrutiny of each request. As a result, not only has the spirit of the law been achieved, but the quality of the projects financed has been assured. Requests for tax-exempt financing are thoroughly reviewed prior to formal application. Of those that do enter the public approval process, many are altered, conditioned, and improved along the way. The process includes review and approval by no less than: The City's Board of Finance, Board of Estimates, Planning Department, Law Department, Zoning Department, Budget and Judiciary Committees of the Council, three (3) readings of the City Council, and the Mayor. Compliance with all local, State and Federal laws in regards to employment, pollution, disclosure, and building codes is mandatory. Additionally, cooperation with the Mayor's Office of Manpower Resources (MOMR) to coordinate the hiring, training, and retention of new employees is a requirement. It is the public purpose priorities that are publicly discussed and challenged, and hence insured, that have contributed significantly to Baltimore's renaissance.

Thank you for the opportunity to present our view before this Committee.

CALIFORNIA STUDENT LOAN FINANCE CORP.,
Los Angeles, Calif., June 16, 1983.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means, Washington, D.C.

Re tax-exempt student loan bonds.

DEAR MR. CHAIRMAN: As an issuer of tax-exempt student loan bonds, I urge that student loan bonds be excluded from any new volume limitations or additional restrictions which may be proposed for IDBs or other "private activity" bonds. I request that this statement be made part of the record of the June 15 and 16 hearing on trends in the use of tax-exempt bonds to finance private activities.

PUBLIC PURPOSE

Your May 24 press release announcing these hearings raises questions about the appropriateness of specific uses of tax-exempt bonds and whether any significant public purpose is served when subsidized financing is provided.

Tax-exempt student loan bonds clearly serve public purposes and fulfill recognized government objectives. The state's direct support of education is supplemented through tax-exempt bond financing of loans for college tuition and related expenses. Moreover, student loans directly benefit those students who need assistance most.

Congress authorized non-profit organizations, such as the California Student Loan Finance Corporation, to issue student loan bonds because the volume of student loans was insufficient to meet students' needs. Many lenders will make student loans only if they can sell such loans to issuers of tax-exempt student loan bonds. Students' needs are continuing and, in the current economy, increasing.

The volume of tax-exempt student loan bonds is relatively slight. According to the Joint Committee's study, they represented less than four percent of total "private activity" bonds in 1982, and two percent of all tax-exempt bonds in that year. They are an appropriate and efficient means of supporting education and are strictly regulated by the Department of Education. For example, the federal subsidy for student loans is reduced if the loans are funded by tax-exempt bonds. Accordingly, further limitations or restrictions on student loan bonds are unnecessary.

VOLUME LIMITATIONS

The May 24 press release also indicates that "some members have indicated their interest in exploring the concept of State-by-State volume limitations". Similarly, the June 13 Joint Committee print for use at the hearings suggests that state-by-state volume limitations might be imposed on private activity bonds and raises the question whether such "restrictions or limitations [should] apply only to tax-exempt IDBs, or to all private activity bonds (including student loan bonds * * *)". No specific volume limitations are suggested.

However, a July 16, 1982, Ways and Means and Joint Committee staff "options" pamphlet suggested a $200 per capita state-by-state limit on the volume of "private purpose" tax-exempt bonds, including student loan bonds. A separate $20 per capita limit for each state on student loan bonds (10 percent of the total limit) was also suggested. These limits would have created serious problems in more than half the states issuing student loan bonds in 1982.

If any such volume limitations are adopted, student loan bond issuers would, at a minimum, have to compete with IDBs and, in California, Texas, and other states which have more than one issuer, among themselves, for allocations of the limit. Costs of issuance would be increased, and funds available to students might be significantly diminished.

Last year, the Administration proposed certain public approval and local government contribution requirements with respect to "private purpose" bonds, including student loan bonds. Congress enacted certain of these requirements in TEFRA for IDBs but appropriately excluded student loan bonds from the additional restrictions. Including student loan bonds in any IDB volume limitation will have the same repressive effects as imposing the public approval requiremetns.

Accordingly, I urge you again to exclude tax-exempt student loan bonds from any proposed volume limitations.

Respectfully submitted.

Jay Olins, *President.*

Chamber of Commerce of the
United States of America,
Washington, D.C., June 15, 1983.

Hon. Daniel Rostenkowski,
Chairman, Committee on Ways and Means, Washington, D.C.

Dear Mr. Chairman: On behalf of the 216,000 members of the U.S. Chamber of Commerce, I urge you and your committee to support continutation of mortgage revenue and industrial development bonds. The current practice of exempting the interest from these bonds from federal taxation should not be changed and the sunset provision for mortgage revenue bonds should be repealed.

These bonds provide a local alternative to further federal involvement in housing and industrial finance. Their continuation is consistent with the recommendations of the President's Housing Commission and the Administration's New Federalism proposal, which emphasizes local initiative.

Federal legislation and regulation relating to these bonds should not result in preventing small business from utilizing this form of financing. Arbitrary restrictions on the amount of bonds to be issued, either in total or for any particular issue, should not be used as a method to prevent small business participation in this type of financing. Nor should other restrictions, such as unworkable arbitrage limitations, be used to prevent any particular segment of the business community from making legitimate use of these types of bonds.

Mortgage revenue and industrial development bonds are useful and valuable tools to encourage community development, economic revitalization, and private sector job creation. Local business community involvement in coordination with reasonable controls enacted by state and local governments can correct isolated abuses and ensure the continued efficient and effective use of these valuable economic development tools.

Thank you for your consideration of our views and I respectfully request that this letter be included in the hearing record on this issue.

Cordially,

HILTON DAVIS,
Vice President, Legislative and Political Affairs.

STATE OF CONNECTICUT, EXECUTIVE CHAMBERS,
Hartford, Conn.

Hon. BARBARA B. KENNELLY,
Member of Congress, Washington, D.C.

DEAR BARBARA: I am writing to you at this time to convey my vigorous opposition to H.R. 1635—the Industrial Development Bond Limitation Act. This legislation threatens the centerpiece of our statewide economic development program in Connecticut at a time when federal resources for economic development have been severely curtailed. Also, in light of the changes to this program enacted through the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982, it is highly questionable whether additional restrictions proposed in this legislation are advisable or even necessary.

We in Connecticut operate a very responsible program. It is our belief that our program, administered by the Connecticut Development Authority (CDA), stands out as a national example of a well-run Industrial Development Bond-backed loan program. Our efforts are aimed primarily at new manufacturing facilities, with commercial projects allowed very selectively in distressed areas. All small issue bonds issued in the state for the purpose of making economic development loans are issued through the CDA. Evidence of the state's commitment to this program is the $300 million backing that has been placed behind our "umbrella bond" program for smaller industries.

The CDA Industrial Development Bond program is the financial centerpiece of our statewide economic development program. The progress that we have been able to achieve in addressing our long term employment needs in the state has been significant. In the last year alone, the CDA's program created or retained 11,500 jobs, primarily in the manufacturing sector which has been the foundation of our state's economy for decades. No other economic development program in Connecticut's history has produced as many new jobs, received as significant a level of state financial commitment, or received the level of widespread bipartisan public support as has our statewide small issue IDB program.

It is distressing to have to consider another series of restrictions on this program so soon after the passage of the restrictions contained in TEFRA. Traditionally, members of Congress have expressed concern about the uses of bond proceeds to fund certain activities such as recreation facilities and certain small commercial enterprises. The passage of TEFRA prohibited the use of bond proceeds to fund a number of these activities—a move we agreed with. Also, in the past, members have raised concerns about the volume of these bonds issued by state and local governments.

It is my belief that last year's legislation has reduced the volume of these bonds issued by the CDA. During the current fiscal year, the CDA's volume of new bond issues approved is substantially lower than one year ago. There is little question that the additional time and expense involved in closing a bond issue in light of TEFRA will have some impact on the volume of bonds issued. Furthermore, one of the main provisions of TEFRA was the requirement that all issues be reported to the Treasury, providing accurate volume data which to date has been unavailable. Further actions to restrict volume should wait until more conclusive data is available.

H.R. 1635 does more than just reduce the volume of small issue IDB's. It would effectively end the usefulness of the program as an economic development tool. Given the present cost and expense of issuing an IBD, the proposed Accelerated Cost Recovery System (ACRS) trade-off alone would make the program extremely uneconomical to operate. For most profitable companies, foregoing the longer-term benefits of ACRS in order to receive upfront assistance through an IDB-backed loan would not be practical. Therefore, many of the investment decisions of the firms relating to initial investment in Connecticut or expansion of present facilities in the state, that might otherwise be made positively from the state's perspective, would be delayed, curtailed, cancelled, or moved elsewhere. The capital expenditure cap in the bill would limit our ability to help subsidiaries of many foreign firms who have recently chosen Connecticut as a site for their North American facilities, and would penalize small, rapidly expanding companies—particularly in the area of high technology. Both of these types of firms are vital sources of new jobs in Connecticut. Finally, the prohibition on financing land, especially as a part of an economic development project, makes no sense whatsoever, unless the intent is to eliminate, rather than limit, the use of IDB-backed loans.

I urge you to oppose the drastic IDB limitation provisions contained in H.R. 1635. There are currently a number of restrictions on this program in existing law in addition to those I have already mentioned, including limitations on the amount of ACRS benefits utilized by a company using IDB financing, capital expenditures limitations on IDB users relative to other investments in the locale of the financed project, prohibitions against refinancings and working capital loans, and a total ban on the use of these bonds after December 31, 1986.

The additional restrictions on this vital program contained in H.R. 1635 could not have come at a worse time. Nationally, unemployment is expected to remain at an unacceptable level for the forseeable future. Federal financial resources available for economic development programs to address this most serious social and personal tragedy have been drastically curtailed. To deny to the states a vital resource now at their disposal to address this issue is unacceptable.

I hope that I can count on your support.

Sincerely,

William A. O'Neill,
Governor.

Statement of the Edison Electric Institute

The Edison Electric Institute (EEI), the national association of the investor-owned electric utility companies, opposes the imposition of any additional restrictions upon the use of industrial development bonds (IDB) financing for the construction of pollution control and certain other facilities. Specifically, EEI opposes the provisions of H.R. 1635 that would lengthen the depreciable lives of such property beyond the established Accelerated Cost Recovery System (ACRS) class lives, and would eliminate the exception for certain pollution control facilities which are installed in connection with existing facilities.

The EEI member companies serve 99 percent of all customers of the investor-owned segment of the industry and 76 percent of all users of electricity in the United States.

The investor-owned utility generally uses IDBs to finance pollution control facilities, sewage and solid waste disposal facilities, and facilities for the local furnishing of electric energy. The Institute urges that no changes be made to present law that would limit the issuance of tax-exempt bonds to finance such facilities or to lessen the tax benefits from their use.

The Institute agrees with the Treasury Department that a valid distinction can be made between quasi-public and strictly private uses of facilities which are financed with IDBs. Clearly, the types of facilities that the electric utility industry finances with tax-exempts serve quasi-public functions. Any legislation to limit IDB financing or to lessen its benefits beyond the restrictions imposed under the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) should apply only to issues that serve strictly private purposes.

Permitting the financing of pollution control facilities and facilities for sewage and solid waste disposal with tax-exempts not only is essential but also is fully justified on grounds that do not apply to tax-exempt financing for most other purposes. First, the use of pollution control and similar facilities does not create a profit for any private party, whereas most other facilities financed with tax-exempts are used for the profit of private parties. Pollution control and similar facilities benefit only the general public, and in an economic sense, they produce only the burden of increased costs of doing business for the user of the facilities. Second, pollution control and similar facilities usually are installed because the law so requires and that is not true of the typical facilities that are financed with tax-exempts. This has two corollaries: The availability of relatively low-cost, tax-exempt money does not cause a misdirection of investments; that is, investment in pollution control and similar facilities is not used as a tax shelter. The other corollary is that a business which is required by government to make an investment has a better claim on help from the government than a business that makes a discretionary investment.

Repeatedly, the local furnishing of electric energy is a quasi-public function. The investor-owned electric utility industry is a regulated industry precisely because the furnishing of electric energy is perceived to serve a public purpose, on which the health and safety of the nation's populace depend. Utilities are required by law to provide adequate electric service, and the use of IDBs for the local furnishing of electric energy is a significant component in the industry's ability to meet the legal requirement to provide adequate, reliable service to customers at reasonable cost.

Existing restrictions that apply to tax-exempt financing of pollution control and certain other facilities already limit their use. "Local furnishing" is defined in the tax law as that which is limited to an area which includes not more than two counties or a city and one contiguous county. This means that very few facilities qualify. With respect to pollution control facilities, the Internal Revenue Service has applied a very restrictive definition; in fact, its definition has been unduly restrictive.

In recent years, there has been criticism of certain uses of IDB financing. In response, Congress enacted significant changes to the IDB provisions of the tax law in TEFRA. Where property is financed by IDBs, these changes generally prohibit the use of the accelerated method in applying the depreciation allowance normally allowed under ACRS. Moreover, IDB financings are now required to be the subject of a public hearing and to be approved by an appropriately responsible elected official. Certainly in the case of a high profile public utility company the latter procedure insures that such financing will serve the general public.

Moreover, in addition to the limitations placed on IDB financing by TEFRA, public utility property generally has not faired well under the Economic Recovery Tax Act of 1981 (ERTA) and under TEFRA. Under ERTA most public utility properties were assigned an ACRS life of 15 years, a longer life than that assigned generally to the property of other industries. Also, the repeal of the repair allowance for property placed in service after 1980 was harmful to most utilities, whereas its effect on most other commercial and industrial taxpayers was minimal. Under TEFRA, the reduction in depreciable basis of property by one half of the amount of the investment tax credit taken, coupled with the necessity of capitalizing the real property taxes and interest relative to the construction period of non-residential real property, is expected to materially increase the tax burden on our capital intensive industry. In addition, TEFRA made public utility property ineligible for safe-harbor and finance leasing.

Congress enacted the IDB program to provide broad public benefits and to stimulate economic development. The use of these bonds for the construction of pollution control facilities, for facilities for the disposal of sewage and solid waste and for the local furnishing of electricity serves these purposes very effectively. Their value and effectiveness should not be diminished any further.

The Institute is grateful for the opportunity to submit its views on this subject.

STATEMENT OF THE FEDERAL PARTY, UNITED STATES OF AMERICA, ALLAN B. COSSENTINE, TEMPORARY SECRETARY-GENERAL

Mr. Chairman, Honorable Members of the Ways and Means Committee, Ladies and Gentlemen: The Federal Party, U.S.A. thanks you again for your kind invitation to appear before you on the subject of tax-exempt bonds issued by state and local governments for the purpose of subsidizing privately-owned projects for the purpose of stimulating business to lower local unemployment, etc.

The intent behind these policies is incontrovertible. With the bound up financial situation in this country, something is better than nothing. But although the patient may feel better with this cure, the cure will inevitably bring on a fatal disease.

The basic problem with this type of approach is the monies generated will not go so much to those who need them, but they will be much more apt to go to those who do not need, but who know how to manipulate to their own improper advantage.

The end result will be that the people will find themselves paying taxes for bonds that will have no relation to themselves or their neighbors and contributing mightily to the unrighteous coffers of the acquisitive.

A bond, interest bearing or not, is a specie. Since local governments are not constitutionally permitted to issue currency, they may issue interest-bearing bonds to finance their own operations when necessary. But to issue bonds for the purpose of financing private industry is effectively the same as issuing greenbacks with the added sad fact that there is an interest bill attached for the people to pay.

The end result of such a policy will be that interest rates will be driven up, investment capital will disappear and new enterprises (which are much needed) will be aborted. And unemployment will get worse.

Not only is the above practice unwise, it is constitutionally unsound, and therefore actually illegal! To propose to control it by taxation will not only beggar the issue but will greatly exacerbate it as well.

The promotion behind the above policies is a conspiracy of the financial interests. Their interest in local tax-exempt bonds stems from just that—tax-exempt.

It would be a shame to apply taxes to local government tax-exempt bonds because there are many legitimate uses of these sources by the local governments which would be stymied by such a tax. Thus acquisition of local public facilities would be quashed by being too expensive.

Mr. Chairman, to explain the Federal Party U.S.A. program for restoring the prosperity of this country through low interest rates which would make the tax-exempt bond financing of private enterprise unnecessary we beg leave to present once again the Chapter #3, of the forthcoming book "The Terminal Tyranny" entitled, "Them as Has, Gits". We thank you very much.

III. THEM AS HAS, GITS

We are not against the practice of collecting rent on money that has been loaned. This is a proper procedure, and those who have money to lend would naturally be expected to be paid for the use of their assets. So we have nothing personal against the banking trade when it seeks to solidify its position and to create stability through seeking the safest source of interest.

Therefore, the problem is not with bankers. The problems is with the laws which we have allowed to stand, which accumulate an obligation that has snowballed into a giant menace, causing our economic problems.

We mentioned earlier in this book that costs which have to be paid by manufacturers or vendors of services will appear in the base cost of their products and in the retail cost it will appear tenfold. The basic solution is not to struggle against particular people, but to merely return to the constitutional position from which we have strayed.

Take, for instance, the one single item of the servicing cost of our national debt. It amounted to $120 billion in 1982. It will automatically be at least $137 billion in 1983, if we don't do anything about it. If we take a gross national product unadjusted at current figures of about $3 trillion (although it may be lower because of the sluggish sales configuration of our economy), subtract the ten times $137.5 billion hypothecated by our ball-park formula of "cost times ten for the consumer", we would be left with a figure of $1.625 trillion to account for in calculating the retail basic cost of our GNP. Which means that we are being charged $1.375 trillion more for the goods and services we need than should be charged! How's that for a rip-off.

The $3 trillion retail cost figure could be shaved somewhat because in the interest paid by the Federal government to the bond holders there might be some intrinsic value. The ten times cost to the consumer formula is based on the idea that no value to the public is received from such expenditure. But that's irrelevant philosophizing.

The real figure we need to study is the $137.5 billion (1983) that we pay out in the servicing of our national debt every year. And that is the trouble—it is not only every year but because every year's interest has to be paid with borrowed money the interest alone will add to the debt, beginning in 1984—$151 billion; in 1985—$175 billion, ad nauseum, (which is Latin for "Its enough to make you barf"). And in addition, in 1983 alone, if the deficit is the projected $200 billion some say it is, then you can add another $63 billion to the amount that will have to be borrowed. Which will make the interest bill go up another $45 billion for 1983 alone, etc, (Latin for "it ain't going to quit").

Not only that—the bloat in the Federal budget also represents a non-return of value for the money expended. It's a wonder that our economy exists, to say nothing of moving ahead. Because it is a primary fact that producers do not pay taxes; they merely add their taxes to the cost of their products and, therefore, consumers pay the taxes. When, as a result, the prices become hideous the consumer is forced to quit buying and economists gallop off in as many wrong directions as there are economists to find the answer. We may not all be producers but we are all consumers. And if consumers have to buy at hideous prices with hideous interest rates—can disaster be far behind?

We are not saying that any or all of this is illegal or immoral, but it certainly is not fattening as far the total population is concerned. What is even more reprehensible is that nobody seems to really conceive of the effect that this has on some of our population who suffer tragically by way of unemployment and accompanying deprivation of the necessities of life. When in the United States, has it ever been permissable for us to allow a situation where families are forced into squatting in tents or living in vans or even sedan cars simply because the economy has caused them to lose their jobs and homes?

We see our advanced nation laying off workers because of the competition of goods from overseas. This competition particularly comes from nations that were defeated in World War II and whose governments were abolished, which abolishment included any and all obligations of the old government.

Therefore as the great statistician, Roger Babson, pointed out in his book. "If Inflation Comes" the governments of both West Germany and Japan have no obligatory costs to add to the prices of their products. They have no interest-bearing bonds left over from previous wars to worry about. Therefore, no wonder that they can manufacture their goods and pay for the shipping of them over to this country at prices less than what we have to charge for our own goods.

As to the interest bill of $137.5 billion (1983), the point is brought home when you consider that this represents over $2,300 a year for a family of four. Remember again, this is paid not by producers, manufacturers or service contractors, but by us, the consumers. When you add to that the $700 billion in unjustifiable expenditures of the government, you come up with a figure of nearly $8,000 above normal Federal tax expectancies per American family. In another way of putting it, a family of four who has only an income of $10,000 a year, by the time they pay their share of the national debt interest and the over-bloat in the budget, arrive at a net income of zilch! No wonder then that government agencies say that families with less than $10,000 income are in the poverty area of the economy. Because after paying the $8,000 for just the folly portion of the Federal budget, they still have to pay the more or less honest costs of state and local governments. So is it any wonder that families making $20,000 or more are considering themselves constantly strapped?

Furthermore while the Reagan budget reduction is facing us in the right direction, it does seem that the bulk of these savings are coming from those programs that were designed to help the poor and unfortunate. The fact that the abandonment or the alteration of the program may result in a substantial savings does not in itself justify that particular action. Now, don't get us wrong. We do believe the Federal government should not be in the business of supporting its citizens. Still, at the same time, it is hard to convince the average citizen and to gainsay the demogogic politicians that the savings scratched off the backs of the poor and unfortunate are not just an imposition upon the helpless.

We therefore proclaim that the best procedure of all would be to monetize the interest-bearing bonds of the Government, which now constitute a national debt of over $1.25 trillion, thus immediately reducing the Federal budget, not by $50 billion, but by $137.5 billion (1983) without threatening either poor people or by robbing the wealthy.

Think of it! Not only could all our citizens feel safe, but there would be from the Federal government no more competition in the money market for the available capital. Anybody with an idea or ambition could obtain thereafter low-cost capital for his enterprise. Actually, companies could substantially reduce prices, and rates and all manufacturing costs could be lowered because of capital savings. This would be a manifold benefit because capital expense is nearing equation with material and labor costs, thus making every business approach a nigh-impossible situation.

The next question would naturally be: Why don't our financial leaders and economic experts see this simple solution? Answer: Don't worry, they do, and they see it very well. In fact, they have been looking at this principle for nearly 300 years since the practice of issuing interest-bearing bonds by governments began.

And in our country, since the beginning of the New Deal, the strongest lobby in Washington has been the lobby which has gotten Congress into all sorts of foreign aid for the purpose of issuing more interest-bearing bonds so that the bond-holders' income can be guaranteed by law. The more bonds, the higher interest, of course. And if the funds given to foreign governments end up as refrigerators and Mercedes for their local mucky-mucks, could the banking conspiracy care less?

But, one may say, "What will this do to our banking institutions?" Answer: If you will look at the average bank statement you will find hundreds of million of dollars in government bonds. If the average interest earnings on the capital represented by these bonds should fall to say 4 percent, the income should still be plenty to pay the gas and lights and the rent on the bank building. Don't worry about the financial institutions. They still have thier principal with which they can do wonders.

After all, with the availability of this capital all our banks and savings and loan offices could get back in the business of making loans again to those who need it and get themselves back in "green" ratings rather than in the "yellow" ratings where 97 percent of all banks and S&Ls find themselves now.

Why are the biggest banks in the U.S. in the yellow (caution) rating? Because of the "making money on money" temptations offered by the world oil and unaligned nations policies into which our government has "pushed" these banks. This is the excuse offered by bankers in their attempt to exercise the same financial control over all nations. And you can bet on it, they'll want the U.S. taxpayer to bail them out!

All right—so enough of this ground laying. What do we do about it?

We have two things to accomplish:

a. Lower the cost of living, buying, selling and making.

b. Repair the economic dislocation which was caused by high unemployment.

To get rid of the budget item of $137.5 billion (1983) yearly interest of U.S. Government bonds is a relatively simple matter. All we need to do is declare that upon a certain date all interest-bearing bonds issued by the Federal government will be monetized for the values they have accrued on that date. By monetization we do not mean exchanging freshly printed dollar bills for these bonds. We mean, instead of being interest-bearing bonds, they will now become in themselves legal tender for the values they have accrued upon that date. For instance; if the bond-holder had bought his bond for $75 some time previously, and it is now worth $82, that bond will now be a $82 bill. The bond-holder will not be able to look to the Federal government for more interest on that bond, but he will be able to go out with it into the market and make loans to any one who wishes to borrow. The net effect to this would be that prime interest would drop probably to a low of 2.5 percent and the average citizen could borrow money at rates bearing from four to five percent. Also the budget would be balanced in a matter of months because the resultant reduction of unemployment would raise the Government's income by a minimum of $150 billion. With a minimal estimate of the deficit being nearly $200 billion in 1983, there would be an effective budgetary surplus of $87.5 billion. This would be more than enough to set Social Security back on the track and as unemployment further decreased, the Government's income could offset the national debt in fifteen years or less.

Not only that, but large institutions such as utilities and other producers have been issuing their bonds and debentures at 12% to 16% because of competition from the Treasury. It competes with them for the available capital just to pay the interest on the national debt. They will now be able to pay off their expensive loans with money that they can borrow at cheaper rates. This would cause the cost of telephone, electricity, gas and other utilities to come down in either costs or being reflected in improved services.

Not surprisingly, conventional wisdom among economists causes a considerable nervous flutter at first when presented with this plan. But deeply ingrained in the science of economics is the feeling that massive distribution of money among the people would be a very direct cause of inflation. We note with amusement the analogy made by Dr. Arthur D. Laffer of U.S.C. in his monthly letter dated April 15, 1982. He speaks of the diminishing returns from a plan such as that of Robin Hood who robbed rich merchants in order to distribute to the poor. Dr. Laffer correctly points out the fact that such a program would soon cut itself off from the source when the merchants either hired guards for themselves, or took a circuitous route around Sherwood forest, thus reducing the availability of further largess to the "poor". The "poor" did not use their gifts for the purposes of further production of goods, but by spending them merely contributed to the further scarcity of that which ws available, thus creating more inflation and reducing them to a still deeper poverty status.

It is necessary to explain, therefore, by following the Robin Hood analogy further that Robin should have taken his ill-gotten treasure and set up a loan program to the people in his area who could prove that they could take the proceeds of such loans and enter into a production of goods, and other forms of business. This would have increased the supplies of goods they needed, thus reducing the price of their necessities. Don't forget, in so doing they would be soon hiring their neighbors, and unemployment would be drastically reduced. This is all we are endeavoring to do with the Federal Party's proposal for the monetization of the Federal interest-bearing bonds. With $1.25 trillion being available for loans, but not for disbursement, we could make financing available at prime interest rates that would serve to wipe out unemployment and enable business to get started again. After all, would you want to build a modern steel plant with all the latest computerized equipment so you could compete with foreign governments, using 10 percent capital? Of course, not! You're no fool either.

The above question is nowhere better illustrated than in the case of the Kaiser Steel plant at Fontana, California. For months the management has been slowing down production, pleading no business and of competition from foreign suppliers. According to a quotation from one of their accountants, the corporation had found it much more profitable to stop making steel and put their capital into interest-bearing investments, such as government bonds, money market certificates, etc. In the meantime, the plant can rust and the workers can starve, for all they care. Their capital now amounts to $¾ billion.

Interest income that is hassle-free beats working any day. Really now, you can't blame the management for taking the best possible care of their stockholders' assets. So it is not the Kaiser management's fault, it is the fault of the laws which we the people have allowed to ascend and stand.

The $1 billion that Congress proposed to use in re-starting the housing business with "low-cost" loans would only, at the most, finance 75,000 dwellings when there is a need for three million units. Does anyone doubt that this would be a way to reduce unemployment? With $1.25 trillion one could build eighty-three million houses, but then we don't need that many houses. We need not only houses but a vast number of other goods and services as well, including much cheaper automobiles, etc.

Unless we do the above proposed programs, the national debt will automatically rise by more than 12 percent per year, causing the interest bill to rise accordingly. This means also that prime interest will also rise at the same rate.

While prime interest seemed to be coming down during the congressional election year of 1982, it was only a political sop which would be reversed when the effects of the prospective vast increase in the coming deficits would be felt. While the election will be over before this book gets into print, we feel safe in predicting that the announced prime interest rates will soar above 25 percent within a year thereafter.

We say "announced" because the hideous spectacle of prime interest being listed at over 25 percent becomes the most monstrous when one realizes that large companies do not pay these prime interest rates. Apparently, these prime interest rate listings are merely for the entertainment of the naive public. According to Jack Anderson, the largest companies are still getting their capital borrowing needs met at rates at least one-third less than the publicly announced prime interest rates. All of which serves to further exacerbate the capitalization troubles of medium and small-sized companies.

Also, even while the announced prime interest might fall to 10 or 11 percent, this is for no more than 1 percent of the population. If any commoner, constituting the other 99 percent of the people should go to his bank and ask for a loan, his rate would still be at the best 20 percent. Try it. You will see that the effective prime interest is still 20 percent!

Therefore, since Federal government borrowing policies constitute the basic cause of these problems, the solution is to change the national policy regarding the financing of Federal needs. Without such competition from the U.S. Treasury for the available capital every year, the private sector would be able to get its powerful production facilties back into gear.

But, basically speaking, it would encourage investment in businesses and in new products and that is the most crying need that we now have in this country. If the high capital cost factor would be eliminated, manufactureres could then cut the costs of the prices of their products and effectively save themselves from the threat of overseas competition. People with ideas for new products would be able to finance them, thus putting other people to work. Within a very measurable length of time unemployment would disappear as a troublesome factor in our economic lives. Furthermore, local government taxes could also be lowered because municipal bonds could be refinanced for lower rates.

Speaking of new products, one feature of a depression is that new ideas and inventions are more plentiful, as noted by U.S. Patent Office employees. So it might be said again that necessity is the mother of invention. We have also considered that laziness might be the natural father (even if illegitimate) thereof and desperation the mid-wife.

In the campaign of 1980 large promises were made day by one of the candidates that he was going to "do something for the auto and steel industires in order to put people back to work." However, this candidate had had the opportunity to "do something" for four years, so apparently the people were not impressed with his sudden concern. They knew that he would produce the same old dreary scenario of "Sweetheart" loans to the owners of the factories at interest rates which would either be subsidized by the tax-payer, or charged to the price of the product. This would have been a mindless repetition of many such scenes in the past.

We repeat—the troubles of both our steel and auto industries are the result of our national indulgence of the privileged financial groups who are now profiteering from both the interest-bearing bonds and the hideously high prime interest set-up, which makes it impossible for the American worker to compete with nations who do not have huge national debts or hog-sized budgets. The question could be asked: "Are we stupid, or are they just not as dumb as we are?"

Bailing out an industry can only provide a short-term solution. And the practice of bailing out private enterprise through local government tax-emept bonds will shortly produce a monster of tax obligations placed on the local tax-payers, and will cure nothing. The Federal Party is only interested in those solutions which will in the final analysis guarantee permanence to the jobs of the workers. This can only be done by bringing down both interest costs by monetizing the federal interest-bearing bonds and by reducing the federal budget by 60 percent or more.

The effect of this reduction on the price of automobiles, for instance, would be at least 20 to 30 percent which, in most cases, would result in a price of up to $4,000 less than the sticker "shockers" now shown. It was commendable for the U.A.W. and the auto companies to get together for the purpose of endeavoring to lower the price of automobiles in order to increase sales. But, the most that can be promised from these negotiations is roughly $200 per car.

The fact of the matter is, compared to taxes and high interest rates, the justifiably reducible wages of the auto workers is comparatively a drop in the bucket. And we can assure you, the long-suffering auto industry, and its customers, that you can get very little foreseeable relief from that direction.

The immediate effect of monetizing the bonds would be that of reducing the average American car's price by 25 percent in a matter of months. The price-reducing effect from Federal tax reduction would certainly fall within a few more weeks. We must remember that Rome was not built in a day, and neither was this mess that we are in. Getting out of it will take at least a few days.

Undoubtedly, the hand-wringing do-gooders will start screaming, "but WHAT are you going to do for the unfortunates?" Our answer: "We're going to put them to work with low-cost capital that is left at home and not going to Washington." Under these circumstances we will not have to fear foreign competition, and our dollar could then be restored to its original soundness.

We could then buy foreign oil for $2.50 a barrel again, and gold could then be bought for $35.00/oz. once more. This will be because we will not be pouring our currency into foreign countries, but keeping our capital at home for our own purposes. This has to be done in order to bring down the cost of living. In the next chapters we will consider a couple of other sources of economic costliness.

CONGRESS OF THE UNITED STATES,
HOUSE OF REPRESENTATIVES,
Washington, D.C., July 28, 1983.

Hon. DAN ROSTENKOWSKI,
Chairman of the House Ways and Means Committee, Washington, D.C.

DEAR DAN: Enclosed you will find a letter from a constitutent who strongly urges that we not further restrict Industrial Development Bond financing.

I believe his letter to be self-explanatory and I wanted you to read it and add it to the Committee record.

Sincerely,

BILL EMERSON, *Member of Congress.*

Enclosure.

THE GATES RUBBER CO.,
Poplar Bluff, Mo., July 6, 1983.

Hon. BILL EMERSON,
House of Representatives, Cape Girardeau, Mo.

DEAR MR. EMERSON: I strongly urge you to reject any further restrictions on Industrial Development Bonds Financing. With the TEFRA restrictions placed on Industrial Development Bonds last January, not enough time has elasped to determine the effect on volume. Further, in a time of economic recovery, a program generating jobs must not be abandoned.

Sincerely,

PERRY A. RHYNE, *Plant Manager.*

Statement of Carter K. Hooks, Director, Economic Development Board of Greene County, Tenn.

INTRODUCTION

The Honorable Don Rostenkowski, Chairman of the Committee on Ways and Means, U.S. House of Representatives, I am Carter K. Hooks, Director of Economic Development for Greeneville, Greene County, Tennessee. We represent approximately 65,000 citizens who wish to continue to improve our economic status of life. I am a certified industrial developer and have been earning my livelihood at this work for approximately 17 years.

GENERAL COMMENTS

It is our belief that Industrial Revenue Bonds should be restricted to capital formation projects. Capital formation projects are defined as businesses that create new capital within the governmental jurisdictions that authorize their issue. They could be further defined as manufacturing, warehousing and distribution. These projects do more to improve the per capita income within a community than they cost in taxes.

Executive Chambers,
Honolulu, Hawaii, June 9, 1983.

Hon. Daniel Rostenkowski,
Chairman, Committee on Ways and Means, Washington, D.C.

Dear Congressman Rostenkowski: I have been informed that the Committee on Ways and Means will hold a hearing on June 14, on H.R. 1176, the Housing Finance Opportunity Act of 1983. I wish to take this opportunity to state my administration's position on this bill and respectfully request that it be included in the records.

H.R. 1176 eliminates the sunset provision of the Mortgage Subsidy Bond Tax Act of 1980, which prohibits the issuance of mortgage revenue bonds after December 31, 1983. Through the issuance of these bonds, we have been able to provide affordable mortgage loans to hundreds of families who, otherwise, would have been unable to own their own homes. We, therefore, strongly support the passage of H.R. 1176.

Through April of this year, 2,261 families have purchased their homes through our Hawaii Housing Authority's housing revenue bond program. This program financed 832 newly-constructed homes and 1,429 existing ones.

To ensure that the program assists families truly in need of assistance, the Hawaii Legislature required the Hawaii Housing Authority to limit participation only to those meeting certain income levels. Furthermore, in accordance with federal law, the authority also limited the purchase price of homes financed with these bonds. The median purchase price of homes purchased through the program was $73,625 in 1980 and $78,250 in 1981 and 1982, prices substantially lower than the statewide average, which ranged from $93,000 for newly-constructed condominium units in 1980 to $190,000 for existing single-family units in 1982.

In conjunction with our housing revenue bond program, the Hawaii Housing Authority implemented a special assistance program to assist lower-income families in purchasing homes. Since this program began in 1982, 66 households have qualified for special assistance. Through the special assistance program, we were able to serve lower-income families despite high mortgage interest rates.

The housing revenue bond program in Hawaii has proved to be extremely successful and worthy of continuation. The sunset of mortgage revenue bonds would eliminate one of the few sources of affordable financing for the purchase of homes in Hawaii.

We strongly endorse the continued use of mortgage revenue bonds and urge you and your colleagues to support H.R. 1176.

With warm personal regards, I remain,

Yours very truly,

George R. Ariyoshi, *Governor.*

State of Hawaii House of Representatives,
Honolulu, Hawaii, June 7, 1983.

Hon. Dan Rostenkowski,
Chairman, House Ways and Means Committee, Washington, D.C.
Re tax-exempt mortgage subsidy bonds.

Dear Chairman Rostenkowski: It is my understanding that the House Ways and Means Committee will hold a hearing on the use of tax-exempt bonds on June 14, 1983. I am sure that you and the members of your committee are aware of the success that the states, including Hawaii, have had with the use of tax-exempt bonds to provide housing for "gap" or moderate-income group families. I urge the committee to support repeal of the 1983 sunset date for these types of bonds to enable the states to continue to address the needs of at least one segment of the housing market as the federal government pulls back more and more from support and involvement in various types of programs, leaving the local governments to contend with the problems, the cessation of authorization to issue tax-exempt housing bonds will be a blow to local efforts to address housing needs.

Hawaii's tax-exempt mortgage bond program, called the Hula Mae program, has enabled over two thousand (2,000) gap group familes to become first-time purchasers of residential units. The state's most recent issuance of $50 million in Hula Mae bonds will enable hundreds more to become homeowners. The Hawaii State Legislature is solidly behind the continuation of authorization to issue tax-exempt revenue bonds for housing and has adopted the enclosed concurrent resolution this session.

Again, I urge favorable action on the repeal or extension of the sunset provision for tax-exempt housing bonds. Thank you for your kind consideration.

Me Ke Aloha Pumehana,

Mazie K. Hirono,
Chairman, Committee on Housing.

Enclosure.

(To be made one and ten copies

FROM THE OFFICE OF
REPRESENTATIVE MAZIE K. HIRONO
Room [illegible]31, State Capitol
Honolulu, Hawaii 96813

HOUSE OF REPRESENTATIVES
TWELFTH LEGISLATURE, 19 83
STATE OF HAWAII

H.C.R. NO. 17

HOUSE CONCURRENT RESOLUTION

RESPECTFULLY URGING THE PRESIDENT AND THE CONGRESS TO AUTHORIZE THE CONTINUED USE OF TAX-EXEMPT REVENUE BONDS AS THE PRIMARY SOURCE OF FUNDING FOR HAWAII'S HULA MAE MORTGAGE LOAN PROGRAM.

WHEREAS, the State of Hawaii recognizes, as one of its primary objectives, the development of greater opportunities for Hawaii's people to secure reasonably priced housing; and

WHEREAS, the increasingly high cost of constructing housing in Hawaii, coupled with high mortgage interest rates, makes it extremely difficult for a moderate income family to purchase their first home; and

WHEREAS, in 1980 the Hawaii Housing Authority began its Hula Mae program to provide necessary financing for first time home owners, and has since issued approximately $200 million in tax-exempt revenue bonds, the proceeds of which were used to finance mortgage loans enabling over 2,000 moderate income families to purchase residential units; and

WHEREAS, the issuance of these bonds was authorized by the Mortgage Subsidy Bond Tax Act of 1980 which also specifies that these revenue bonds may not be issued after December 31, 1983, thereby jeopardizing the State's ability to further finance the purchase of housing by moderate income families; now, therefore,

BE IT RESOLVED by the House of Representatives of the Twelfth Legislature of the State of Hawaii, Regular Session of 1983, the Senate concurring, that the President of the United States and the Congress of the United States are respectfully urged to support, in view of its great success, the continued use of tax-exempt revenue bonds as the primary source of funds for the Hula Mae mortgage loan program either through the extension or through the elimination of the tax-exempt revenue bond sunset clause of the Mortgage Subsidy Bond Tax Act of 1980; and

H.C.R. NO. 17

BE IT FURTHER RESOLVED that certified copies of this Concurrent Resolution be transmitted to the President of the United States, the President of the United States Senate, the Speaker of the United States House of Representatives, and members of Hawaii's congressional delegation.

OFFERED BY: Mazie Hirono

JAN 25 1983

Rod Tam

Connie Chun

Alfred O. Lardizabal

Joan Hayes

Kathleen G. Stanley

Gene Albano

Mike Crozier

Clayton Hee

Herbert J. Honda

Richard M. Matsuura

Norma Wong

Robert S. Nakata

Peter K. Apo

FROM THE OFFICE OF
REPRESENTATIVE MAZIE K. HIRONO
Room 331, State Capitol
Honolulu, Hawaii 96813

STAND. COM. REP. NO. 65

Honolulu, Hawaii

March 1, 1983

RE: H.C.R. NO. 17

The Honorable Henry Haalilio Peters
Speaker, House of Representatives
Twelfth State Legislature
Regular Session of 1983
State of Hawaii

Sir:

Your Committee on Housing to which was referred H.C.R. No. 17 entitled: "HOUSE CONCURRENT RESOLUTION RESPECTFULLY URGING THE PRESIDENT AND THE CONGRESS TO AUTHORIZE THE CONTINUED USE OF TAX-EXEMPT REVENUE BONDS AS THE PRIMARY SOURCE OF FUNDING FOR HAWAII'S HULA MAE MORTGAGE LOAN PROGRAM", begs leave to report as follows:

The purpose of this concurrent resolution is to encourage the President and Congress of the United States to support legislation allowing continuation of the use of tax-exempt revenue bonds as the primary source of funds for the Hula Mae mortgage loan program through extension or elimination of the sunset clause of the Mortgage Subsidy Bond Tax Act of 1980. The Mortgage Subsidy Bond Tax of 1980 specifies that tax-exempt revenue bonds, for the purpose of financing mortgage loans, may not be issued after December 31, 1983.

Your Committee finds that the Hula Mae mortgage loan program has been very successful in providing mortgage loans at affordable interest rates. The source of funding for this program has been tax-exempt revenue bonds; without federal authorization to issue these bonds, the program will end.

Your Committee on Housing concurs with the intent and purpose of H.C.R. No. 17 and recommends its adoption.

Respectfully submitted,

Mazie Hirono
MAZIE K. HIRONO, Chairman

Rod Tam
ROD TAM, Vice Chairman

STAND. COM. REP. NO. 65
Page 2

Peter K. Apo

MARK ANDREWS, Member
PETER APO, Member

Byron W Baker
Connie Chun

BYRON BAKER, Member
CONNIE CHUN, Member

David Hagino

DAVID HAGINO, Member
MARSHALL IGE, Member

Donna Ikeda
Hal Jones

DONNA IKEDA, Member
HAL JONES, Member

Joseph Leong

KEN KIYABU, Member
JOSEPH LEONG, Member

Mitsuo Shito

ARNOLD MORGADO, Member
MITSUO SHITO, Member

TERRANCE TOM, Member

s-1148

FROM THE OFFICE OF
REPRESENTATIVE MAZIE K. HIRONO
Room 331, State Capitol
Honolulu, Hawaii 96813

STANDING COMMITTEE REPORT NO. 1029

Honolulu, Hawaii
4/21, 1983

Honorable Richard S.H. Wong
President of the Senate
Twelfth State Legislature
Regular Session of 1983
State of Hawaii

Sir:

RE: H.C.R. No. 17

Your Committee on Housing and Urban Development, to which was referred H.C.R. No. 17 entitled:

> "HOUSE CONCURRENT RESOLUTION RESPECTFULLY URGING THE PRESIDENT AND THE CONGRESS TO AUTHORIZE THE CONTINUED USE OF TAX-EXEMPT REVENUE BONDS AS THE PRIMARY SOURCE OF FUNDING FOR HAWAII'S HULA MAE MORTGAGE LOAN PROGRAM",

begs leave to report as follows:

The purpose of this House concurrent resolution is to encourage the President and Congress of the United States to support legislation allowing continuation of the use of tax-exempt revenue bonds as the primary source of funds for the Hula Mae mortgage loan program through extension or elimination of the sunset clause of the Mortgage Subsidy Bond Tax Act of 1980. The Mortgage Subsidy Bond Tax of 1980 specifies that tax-exempt revenue bonds, for the purpose of financing mortgage loans, may not be issued after December 31, 1983.

Your Committee finds that the Hula Mae mortgage loan program has been very successful in providing mortgage loans at affordable interest rates. The program will end unless the federal government allows the continued use of tax-exempt revenue bonds.

Your Committee on Housing and Urban Development concurs with the intent and purpose of H.C.R. No. 17 and recommends its adoption.

Respectfully submitted,

Patsy K. Young

PATSY K. YOUNG, Chairman

SMA-K015

s-1148

STANDING COMMITTEE REPORT NO. 1029
Page 2

Milton Holt
MILTON HOLT, Vice-Chairman

Steve Cobb
STEVE COBB, Member

Excused
MAMORU YAMASAKI, Member

RALPH K. AJIFU, Member

SMA-K015

HEALTH CARE FINANCING STUDY GROUP

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Merrill Lynch White Weld
Capital Markets Group

Vice Chairman:
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STATEMENT OF THE HEALTH CARE FINANCING STUDY GROUP ON HEALTH CARE TAX-EXEMPT FINANCING

Submitted to the Committee on Ways and Means
of the House of Representatives
June 17, 1983

The Health Care Financing Study Group (HCFSG) is an informal association of hospital investment bankers, together with law firms, accounting firms, and consulting firms which become involved in long-debt financings for health care facilities. The HCFSG is pleased to submit its study, "The Uses and Impacts of Hospital Tax-Exempt Financing," a copy of which is attached. We believe that this study should be reviewed by the Committee as it considers trends in municipal financing and the use of tax-exempt bonds to finance private activities. The principal conclusions of this study are as follows:

1. Tax-exempt bonds play an important role in helping hospitals hold down costs.

   If hospitals had been unable to utilize tax-exempt financing, their costs and charges would have increased by an average of 7 percent over current levels, unless they allowed their financial positions to decline. This increase would contribute to inflation and would have an adverse impact on the federal budget through the Medicare/Medicaid reimbursement system and through inflation-indexed transfer payments.

2. Tax-exempt bonds have been instrumental in helping hospitals maintain their financial position.

   Without the use of tax-exempt bonds, the financial position of many of the nation's hospitals would deteriorate, unless charges were increased significantly. If taxable bonds were used instead of tax-exempt bonds to finance hospital capital projects, debt service coverage ratios would drop for most hospitals, resulting in a bond rating drop of one rating class. Taxable bond use would also lead to higher debt-to-equity ratios, less available working capital, and potential erosion of hospital endowments -- all leading to a weaker financial position for hospitals.

3. The growth of hospital tax-exempt financing has not led to a boom in hospital construction and the addition of new beds.

   While the volume of tax-exempt hospital bonds issued increased nearly 580 percent in constant dollars between 1971 and 1980, the volume of hospital construction fell by 34 percent in constant dollar terms during the same period. The supply of hospital beds, moreover, is growing very slowly, if at all.

4. Tax-exempt hospital bonds cost the federal government very little, if anything; they may even be net revenue producers for the Treasury.

   Current governmental estimates of direct tax revenue losses caused by hospital bonds are based upon unrealistic assumptions and are seriously inflated. The estimate of the Congressional Budget Office that hospital bonds resulted in $400 million in tax revenues lost during 1980, appears to be overstated by a factor of 6 or 7. In contrast, hospital tax-exempt bonds save hospital interest expenses, thus cutting Medicare and Medicaid reimbursement for these costs. During 1980, these Medicare/Medicaid savings appear to have been at least $150 million. In addition, the bonds stimulate the creation of jobs, new economic activity, and additional tax revenues. On balance, tax-exempt hospital bonds may actually save the Treasury money when all factors are considered.

5. The use of tax-exempt hospital bonds, which grew rapidly during the early and mid-1970s, has settled into a pattern of slow growth in recent years.

   During the early and mid-1980s, the use of tax-exempt bonds to finance hospital capital projects jumped, primarily for two reasons. First, other sources of capital funding, such as government grants and philanthropy, shrank markedly. Second, the legal mechanisms required to sell the bonds, such as public bond authorities, were not set up in many areas until the 1970s. In recent years, bond use has increased at a much slower pace than in the past, particularly when measured in constant dollars.

6. While construction is the most important use of tax-exempt capital by hospitals, other uses are important.

   "Project costs" (i.e., construction, equipment, and architectural and engineering fees) consumed between 60 and 65 percent of the funds raised by hospitals through tax-exempt bonds during recent years. Refinancing of prior debt and the investor-required debt service reserve each accounted for 10 percent of the funds. Capitalized construction period interest accounted for an additional 13 percent of the funds. Transaction costs (i.e., legal fees, printing, feasibility study, bond discount) are less than 5 percent of the total.

7. Tax-exempt bonds are needed to play a vital role in the future capital financing plans of the nation's hospitals.

   During the decade of the 1980s, capital formation will be crucial to the survival of the nation's hospitals. Yet, elimination of tax-exempt financing would bar one-third of the nation's hospitals from access to the private capital market. The need for secure access to capital will be great as hospitals face the challenges ahead, and tax-exempt bonds will play an important role in providing the capital needed by hospitals.

There are several additional points which Congress should consider in any review of the use of tax-exempt bonds by non-profit charitable hospitals. First, these bonds serve a public purpose. The tax-exempt status of a non-profit hospital under Section 501(c)(3) of the Internal Revenue Code establishes that this institution and its activities, including its long-term capital financing, are in the public interest according to the Congressionally established criteria for tax-exempt organizations. Second, the health planning system, with a certificate-of-need program effective in virtually every state, guarantees that there can be no uncontrolled building of unneeded hospital beds. Indeed, the vast bulk of hospital construction funds in recent years have gone for needed modernization, renovation and replacement, rather than for expansion of bed capacity. Third, much of the current volume of health care facility long-term tax-exempt financing can be traced to the abnormally high interest rates of 1980 and 1981. Interest rates have been declining steadily over the last year. During this period, many hospital issues, which had been held back during the previous two years, were brought to market. In addition, many of the high-interest-rate issues of 1980 and 1981 have been refinanced at lower interest rates during recent months through the issuance of new tax-exempt debt. The result has been further upward pressure on hospital bond volume. In any event, the certificate-of-need system is a guardian now, as it has been in the past, against unwarranted hospital construction projects.

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THE USES AND IMPACTS OF HOSPITAL TAX-EXEMPT FINANCING

May, 1982

THE USES AND IMPACTS OF HOSPITAL TAX-EXEMPT FINANCING

I. INTRODUCTION

The use of tax-exempt financing by hospitals has grown dramatically during the last decade. The year 1971 saw the issue of only $.26 billion worth of tax-exempt hospital bonds. By 1981 that number had risen to $5.04 billion. 1/

This rapid growth in the use of hospital tax-exempt bonds has occurred during a decade of increasing concern over rising health care costs. This concern has led to several efforts to curtail health care economic activity, including proposals to constrain hospital operating costs and hospital construction. With the inauguration of a new Administration in 1981, the search for cures to the problem of rising health care costs turned away from regulatory solutions and toward competition and deregulation. Yet the overriding concern with controlling health care costs, and particularly with controlling the federal government's share of that cost burden through Medicare and Medicaid, remains.

Given, the rapid growth in the use of tax-exempt bonds by hospitals and the continuing concern over soaring hospital costs during the last decade, it comes as no surprise that health policy makers have begun to raise questions about the role of hospital tax-exempt financing in the health care cost equation. 2/ These questions have often been raised as part of two distinct broader policy issues. First, hospital tax-exempt bonds have been included with other forms of tax subsidies for medical care such as the "employer exclusion" and the personal deduction for medical expenses. 3/ This broader question -- the impact of the health-related provisions of the Internal Revenue Code on the health care cost equation and on the structure of the health care industry -- has been much on the mind of health policy thinkers both inside and outside the Administration during 1981 and 1982.

1/ For 1971, Congressional Budget Office, "Tax Subsidies for Medical Care: Current Policies and Possible Alternatives," Washington: Government Printing Office, 1980 (hereinafter CBO Report), at 49; for 1981, The Weekly Bond Buyer, January 25, 1982, at 1.

2/ CBO Report, at 47-54; 126 Cong. Rec. H4383-H4384 (daily ed. May 30, 1980).

3/ CBO Report, at 1-5.

Second, hospital tax-exempt bonds have been caught up in the controversy over tax-exempt financing generally. This controversy, which has centered on the use of tax-exempt small-issue industrial development bonds (IDBs), led the Department of Treasury in February of 1982 to propose a new set of requirements for issuance of tax-exempt bonds. Despite the growing attention paid to tax subsidies in health care and to tax-exempt financing generally, the use of tax-exempt bonds by hospitals has received scant study. Yet clearly, more study is needed. In May of 1981, the Health Care Financing Study Group (HCFSG) determined to help fill this need.

The HCFSG is an informal association whose member firms participate in hospital capital financing transactions. Its members include hospital investment banking and underwriting firms, law firms with bond counsel expertise, accounting firms, and hospital consulting firms. In order to investigate hospital tax-exempt financing and its related policy questions, a special committee of member firms was formed. These firms supplied many man-hours of skilled professional work in conducting the research and generating the results which are reflected in this report.

The narrative of this report sets out and discusses the HCFSG's findings. Supporting statistical data and methodologies are reproduced in the appendixes, as appropriate. The HCFSG's investigation of the uses and impacts of hospital tax-exempt financing has fallen into four broad areas:

-- First, we quantitatively assessed the actual growth in the use of hospital tax-exempt financing over the last decade.

-- Second, we analyzed the uses to which hospitals put the funds which they derived from the sale of tax-exempt bonds.

-- Third, in our major area of inquiry, and one which is perhaps the heart of this report, we focused on the various impacts of hospital tax-exempt financing. Specifically, we considered the impact of tax-exempt bonds on hospital costs, hospital financial condition, hospital construction and on the federal budget.

-- Fourth, we considered the future of hospital tax-exempt financing. Our view of the future necessarily contains elements of speculation. Yet, with the hospital industry facing wholesale restructuring and an unprecedented demand for capital during the next decade, informed speculation about the future is imperative.

II. THE GROWTH OF HOSPITAL TAX-EXEMPT FINANCING

During the last decade, the volume of tax-exempt financing used by the nation's hospitals has increased dramatically, at least when measured in current dollars. Table 1 shows a current dollar increase in annual volume over the decade from $.26 billion to over $5 billion.

TABLE 1

TAX-EXEMPT HOSPITAL BONDS ISSUED, 1971-1981, IN CURRENT AND CONSTANT DOLLARS (In Millions) [4]

	Current $	Constant (1967) $
1971	$ 262.0	$ 216.0
1972	525.0	419.0
1973	610.6	458.3
1974	1,282.4	868.2
1975	1,959.0	1,215.3
1976	2,725.6	1,598.6
1977	4,731.5	2,606.9
1978	3,121.8	1,597.6
1979	3,153.5	1,450.6
1980	3,624.0	1,468.4
1981	5,040.0	1,850.2

While growth in the current dollar value of hospital tax-exempt issues has been dramatic, it has also been unsteady. There was a quick run-up in annual volume from below $1 billion in 1973 to $4.7 billion in 1977. For the next three years, volume hovered between $3 billion and $4 billion. For 1981, there was another burst upward to $5 billion.

In retrospect, it is clear that the high volume in 1977 was abnormal. It reflected a surge of refinancings which occurred when a sudden lowering of interest rates followed the temporary bulge in rates caused by the New York City default in 1975. The more recent surge in volume from $3.6 billion in 1980 to $5 billion in 1981 is also attributable to the vagaries of interest rates. In 1980, interest rates remained consistently in the double digits for the first time. As a result, many hospitals deferred their issues, hoping for a downturn in rates. As it turned out, 1981 saw no overwhelming improvement in rates. Yet some of 1980's pent-up demand broke through, producing the surge in 1981's volume. Without the rate-induced project deferrals of 1980, the "normal" volume for those two years might have been on the order of $4.0 billion for 1980 and $4.6 billion for 1981, with no sharp jump between the two years.

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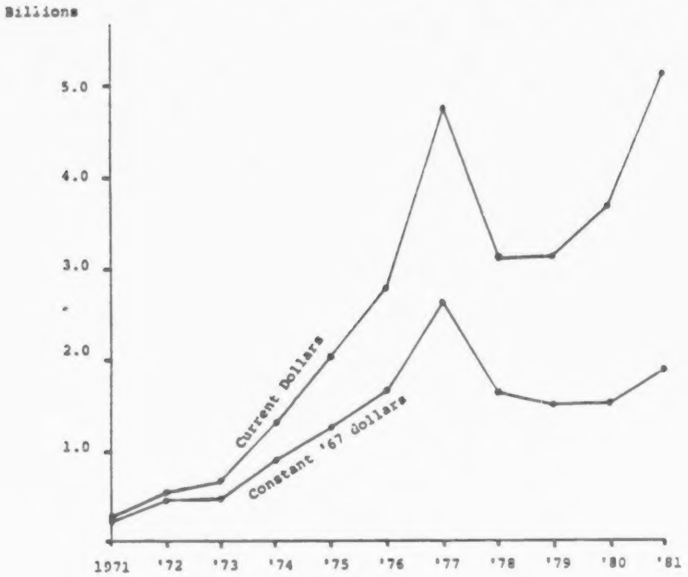
[4] For 1971-79, CBO Report, Table 7, at 49; for 1980, Public Securities Association; for 1981, Weekly Bond Buyer, supra (figures adjusted for growth in Consumer Price Index).

Much of the increase during the 1970s in the volume of hospital tax-exempt bonds issued is traceable to inflation. Just how much becomes clear when the increases are expressed in constant dollars, as in the right-hand column of Table 1. As measured in 1967 dollars, there is a growth from $.22 billion in 1971 to $1.85 billion in 1981. But most of that growth -- almost exactly $1 billion of it -- occurred during the early 1970s, while hospital tax-exempt financing was still struggling for acceptance among hospitals and in the marketplace as a financing tool. By 1975, hospital tax-exempt bonds had attained a certain maturity as a financing device. During the six years from 1975 to 1981, issuance of these bonds grew from $1.22 billion to $1.85 billion in 1967 dollars, a solid -- but not spectacular -- gain of a little over 50 percent. Growth in issuance levels for tax-exempt hospital bonds, as measured both in current and constant dollars, is shown graphically in Chart 1.

CHART 1

TAX-EXEMPT HOSPITAL BONDS ISSUED, 1971-1981 [5]



For a variety of reasons, tax-exempt bonds have become the predominant source of capital financing available to most hospitals. As Table 2 shows, between 1973 and 1978 the sources of funding utilized for hospital capital projects changed markedly. Funding from traditional sources of hospital capital, such as government grants and philanthropy, declined significantly. So did the use of other sources of capital, such as direct loans and taxable bonds. To compensate for the drying-up of traditional sources of capital, hospitals slightly increased their use of internally generated funds, and significantly increased their use of tax-exempt bonds.

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[5] The data for this chart are taken from Table 1, supra.

TABLE 2

SOURCES OF FUNDING FOR HOSPITAL CONSTRUCTION [6/]

	1973	1978
Government Grants and Appropriations	23.5%	8.6%
Philanthropy	10.4%	6.2%
Taxable Bonds	4.8%	2.8%
Direct Loans	17.0%	8.0%
Internal Funds	16.4%	18.5%
Tax-Exempt Bonds	20.9%	49.3%

There are a number of reasons for the changes in hospital capital sources noted in Table 2. First, government appropriations and grants to hospitals have been reduced to almost nominal levels. Several factors, apparently including the cost-based reimbursement system, have resulted in a decline in the volume of philanthropic giving to hospitals. The Economic Recovery Tax Act of 1981 is expected to contribute to this decline. By reducing the highest personal tax bracket from 70 percent to 50 percent, it reduces much of the incentive for philanthropic contributions. The capital needs of today's hospitals are too large to be satisfied through the use of direct loans and mortgages. Further, taxable bonds are no longer a viable option for most hospitals. Many institutions do not possess the high credit-worthiness (A-rated or better) needed for access to the taxable bond market. Even hospitals which have access to the taxable market are often deterred by the relatively high annual costs which result from the market-dictated high interest rate and short 15-year (or less) payback period.

These changes leave hospitals with few options for obtaining needed capital. Despite a slight increase in the use of internally generated capital between 1973 and 1978, internal funds are not a strong source for the future. Substantial internal accumulation is made very difficult, if not impossible, by the failure of Medicare and Medicaid to reimburse hospitals

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[6/] American Hospital Association, "Report on Tax-Exempt Hospital Financing," unpublished paper, 1980, at 5.

the full financial requirements of health care services. For example, Medicare does not pay a return on equity for nonprofit hospitals, even though a return on investment is a business necessity. Further, Medicare reimburses for depreciation based on historical cost, a method which is seriously inadequate given current economic conditions. 7/ This leads to fiscal erosion for many hospitals, making it increasingly difficult for them to set aside capital for construction or renovation projects.

While the volume of hospital tax-exempt bonds increased dramatically during the last decade, 8/ the overall level of capital financing used by the nation's hospitals increased only slightly during this time. In fact, Table 3 shows that between 1971 and 1980 the dollar volume of hospital construction projects completed decreased in terms of constant dollars. As Table 2 shows, hospital tax-exempt bonds fill the gap left by reductions

TABLE 3

VOLUME OF HOSPITAL
CONSTRUCTION
PROJECTS COMPLETED, 1971-1980 9/

	Current $ Millions	Constant 1967 $ Millions
1971	$3,845	$2,872
1972	4,180	2,966
1973	4,154	2,720
1974	4,439	2,430
1975	4,954	2,527
1976	5,266	2,677
1977	5,023	2,407
1978	5,169	2,214
1979	5,178	1,889
1980	5,831	1,883

7/ Congress recognized the inadequacy of historical cost depreciation in the Economic Recovery Tax Act of 1981, when it legitimized the Accelerated Cost Recovery System (ACRS). However, HHS has been allowed to waive the ACRS depreciation schedules for purposes of Medicare and Medicaid reimbursement.

8/ CBO Report, at 49.

9/ U.S. Bureau of the Census.

in other sources of hospital capital. Thus, the rapidly increasing volume of tax-exempt hospital bonds has not led to any dramatic increase in hospital capital projects. Rather, it has enabled hospitals to continue to carry out needed hospital projects which were formerly financed by other sources of capital. In short, tax-exempt hospital financing has been a growing slice of a shrinking pie.

TABLE 4

TAX-EXEMPT HOSPITAL BOND VOLUME AND TOTAL MUNICIPAL BOND VOLUME: PERCENT CHANGE IN CURRENT AND CONSTANT DOLLARS, 1977-1980 (In Millions) 10/

Use of Proceeds	Current Dollars		Percent Change in Current Dollars
	1977	1980	
Hospital Issues	$ 3,329	$ 3,624	+ 8.9%
Total Municipal New Issues	$36,233	$46,599	+28.6%
	Constant (1967) Dollars		Percent Change in Constant Dollars
	1977	1980	
Hospital Issues	$ 1,834	$ 1,468	-20.0%
Total Municipal New Issues	$19,963	$18,881	- 5.4%

It is important to note that, as Table 4 shows, tax-exempt hospital bonds are a relatively small and stable segment of the overall tax-exempt bond market. According to the Public Securities Association, hospital tax-exempt bonds accounted for

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10/ The data in Table 4 are drawn from the Public Securities Association. The 1977 figure for hospital issues, $3.329 billion, is different from the 1977 figure in Table 1, *supra*, which is derived from the CBO Report. See Appendix A for further discussion of hospital issues as a part of the overall municipal bond market.

just over nine percent of all new municipal tax-exempt financing in 1977. In 1980, tax-exempt hospital bonds accounted for less than eight percent of the total. However, hospital issues grew to 11 percent of the long-term tax-exempt market for 1981. This growth in hospital issues' share of the total reflected 1980's pent-up demand which flooded to the market during 1981. 11/

11/ See Appendix A, especially Table A-2 therein; Weekly Bond Buyer, supra.

III. THE USES OF HOSPITAL TAX-EXEMPT BONDS

A. Statistical Summary

The capital projects of America's hospitals, financed primarily with tax-exempt bonds, are used for a wide variety of purposes. Table 5 shows the uses of hospital capital by nature of cost during 1980 and 1981.

TABLE 5

USES OF HOSPITAL CAPITAL 12/

Project Costs:		1980		1981
Equipment[a]	6.62%		4.28%	
Architecture & Engineering Fees	4.50		3.04	
Construction Costs	54.02		52.22	
Total		65.14%		59.54%
Refinancing		9.21		10.84
Issuance Costs[b]		1.19		1.38
Bond Discount		2.60		3.38
Debt Service Reserve Fund		8.98		9.88
Capitalized Interest Fund		12.78		13.87
Other Costs		.10		1.11
		100.00%		100.00%

[a] This is usually movable equipment. Most fixed equipment is included in the construction costs.

[b] Legal fees, printing, financial feasibility, etc.

12/ See Appendix B for an explanation of the data base and methodology by which Table 5 is derived.

It is clear from the preceding table that the bulk of hospital capital raised through the sale of tax-exempt bonds goes to meet the project costs. These are the so-called "hard costs" of equipment, architectural and engineering fees, and construction. Construction costs far outstrip the other two. Taken together, these project costs claimed 65 percent of hospital tax-exempt capital raised during 1980 and 60 percent during 1981. Two separate funds, the debt service reserve fund and the capitalized interest fund, claimed significant portions of bond sale proceeds during 1980 and 1981. The investor-required debt service reserve claimed slightly less than 10 percent of the funds. The capitalized interest fund needed to service the debt during the temporary construction period claimed approximately 13 percent. Refinancing accounted for over nine percent of hospital tax-exempt capital in 1980, and for nearly 11 percent in 1981. The transaction costs, i.e., legal fees, printing costs, feasibility study, and underwriter's discount, accounted for four to five percent of the sale proceeds.

B. Four Case Studies

A hospital tax-exempt capital project may serve a number of purposes:

- renovation of existing facilities;
- expansion of ancillary and support service areas;
- renovation and/or replacement of existing inpatient facilities;
- construction of medical office buildings and facilities for ambulatory care;
- mergers and acquisitions of separate health care institutions;
- reorganization of existing inpatient services and the introduction of new services; and
- addition of new beds and services to meet a growth in service area population.

Few hospital projects involve all of the purposes listed above. Many, however, involve several of these purposes. The following case studies are intended to illustrate the types of purposes for which tax-exempt hospital bonds are issued.

1. Renovation/Reorganization Project With Net Bed Loss, In Small City

In February, 1981, the Massachusetts Health and Education Facilities Authority (MHEFA) issued $33,300,000 of tax-exempt bonds on behalf of Brockton Hospital. Brockton Hospital is a 308 bed private, nonprofit acute care hospital, which provides a full range of patient services, including maternity services and medical and radiation oncology. The hospital is the largest provider of hospital-based ambulatory care in Southeastern Massachusetts, maintaining 25 different outpatient clinics.

Brockton Hospital originally opened in 1895 as a 20 bed facility. It expanded to 78 beds in 1930 and again in 1952 to 218 beds. During the late 1950s and early 1960s two additional wings were added to the hospital bringing its bed count to 336. The hospital's facilities prior to the February, 1981 financing included 13 separate buildings, six of which were interconnected. Because of their age, many of the buildings comprising the hospital's facilities were inadequately constructed to meet current patient service needs. Likewise, the haphazard, building-by-building expansion of the hospital's facilities had resulted in significant operating inefficiencies.

The primary purpose of Brockton's project was to provide for the renovation and reorganization of a major portion of the existing hospital facilities and significant new construction to provide space for existing services. In particular, the project would allow the hospital to expand its services in cancer medicine. Brockton Hospital serves as a regional center for cancer management and inpatient psychiatry (the hospital's new 25 bed inpatient psychiatric service was designed to replace state hospital beds being closed by the Massachusetts Department of Mental Health).

While the project expanded the hospital's inpatient psychiatric bed complement, this increase was offset by a reduction in medical/surgical beds from 247 to 217. As a result, the hospital's licensed bed capacity was cut from 308 to 301.

In addition to the renovations and new construction to its inpatient services, expansion and improvement of the emergency departments and outpatient clinic facilities planned as part of the project were designed to permit the hospital to efficiently respond to its service area's increased needs for emergency and outpatient services and to increase the occupancy of medical/surgical beds. The new facilities for the outpatient clinics will allow the hospital to continue to provide primary and specialty services fully staffed on a scheduled basis. The pediatric clinic, temporarily located elsewhere, would be brought back to the hospital, and a new walk-in triage clinic would redirect non-urgent patients from the emergency room to a primary care setting to encourage continuity of care.

The project was approved by the City of Brockton, the area-wide Health Systems Agency, and the state's Department of Mental Health. It also received a Determination of Need approval from the Massachusetts Department of Public Health.

The Brockton Hospital project, outlined above, is indicative of the vast majority of projects financed with the proceeds of tax-exempt bonds. By combining extensive renovations and new construction with an overall reorganization of its inpatient service mix, the hospital was able to make its operations more efficient and its services more responsive to the community it serves.

2. Construction of Ambulatory Care Facility

Massachusetts General Hospital (MGH) is the third oldest private, voluntary, nonprofit hospital in the United States. MGH has consistently been the site of new advances in medical science and health care delivery. MGH is known primarily for its inpatient programs and services and research activities. It operates 1082 beds, is a regional referral center for virtually all medical specialties and subspecialties, and is known worldwide for its advances in medical research. A lesser known fact is that MGH is also a major provider of outpatient or ambulatory services, with over half a million ambulatory visits per year.

The problem which the hospital faced in 1978 was that the broad spectrum of ambulatory services it delivered were scattered throughout almost all of its existing buildings. Like hospitals nationwide, MGH had experienced a large increase in the volume of such services, to the point that existing facilities used for ambulatory care were inefficient and were operating at or beyond normal capacity. In order to develop a coherent, organized program for ambulatory care for the future, and to provide equitable, efficient ambulatory services for all, it became apparent that a single facility was needed which would consolidate these activities in a common setting.

After extensive planning and following the receipt of all necessary approvals, MGH raised nearly $30 million from a $60 million issue which was sold in the spring of 1979 (the other $30 million refinanced debt already outstanding) to provide financing for a new ambulatory care facility. This facility would integrate private physicians' offices, clinics, outpatient surgical facilities, and the necessary medical support activities into a single facility to provide high quality and cost-effective ambulatory care.

As noted above, the growth in ambulatory care visits at MGH throughout the 1970s is indicative of a widespread national trend, which has carried over into the 1980s as well. To meet the increased demand for services provided on an outpatient basis, many hospitals are finding it necessary to reorganize and modernize their facilities for providing ambulatory care. Many hospitals are doing so in conjunction with reductions in their inpatient beds and services. This is a trend which may eventually lead to significant systemwide savings in health care costs.

3. Acquisition Capital to Create a Consolidated Three-Hospital System

In June of 1981, The Hospitals Authority of Philadelphia sold approximately $55,500,000 in tax-exempt revenue bonds on behalf of Metropolitan Hospital. The primary purpose of the bond issue was to finance Metropolitan's acquisition of and improvements to two Philadelphia area hospitals (Parkview Hospital, a 223 bed facility and Tri-County Hospital, which operates 196 beds). The two hospitals were previously owned by a large for-profit hospital system. As a result of the acquisition, Metropolitan's licensed bed complement increased from 215 at a single site to a total of 634 beds at 3 separate locations.

Metropolitan Hospital was established as a not-for-profit corporation in 1945. Since its inception, Metropolitan had operated at four different locations and increased its original 28 bed capacity six different times. Metropolitan moved to its present location and facility in 1971 in cooperation with the Philadelphia Redevelopment Authority and the City of Philadelphia. The ten-story, twin-towered structure located in center-city Philadelphia houses the Hospital's 215 acute care beds and a wide range of ancillary medical facilities.

Metropolitan's existing facilities, located on a 2.4 acre site, consisted of two interconnected towers. The hospital provides a range of services including internal medicine, surgery, renal dialysis, obstetrics and gynecology, operating suites, recovery rooms, pathology and laboratory services, radiology and its sub-specialties, rehabilitation medicine, a 24-hour licensed physician-staffed emergency room, and special care units (intensive care, coronary care, and maximum care). The hospital is a major clinical teaching institution approved by the American Osteopathic Association, the Pennsylvania State Board of Osteopathic Examiners and the American Podiatry Association.

The geographic area served by Metropolitan Hospital in the year prior to the acquisition included all of Parkview Hospital's service area and nearly all of Tri-County's service area. Because of their location and common osteopathic orientation, several members of Metropolitan's medical staff served on the staff of either Parkview or Tri-County.

The larger of the two hospitals being acquired, Parkview Hospital, was a 223 bed acute care osteopathic facility located in Northeast Philadelphia. Services provided by Parkview Hospital include inpatient acute services for medical, surgical, pediatric and obstetrics/gynecological patients, as well as specialized care in its intensive care and coronary care units. To support these inpatient services, Parkview provides various ambulatory and ancillary support services including laboratory, radiology, rehabilitation medicine, respiratory therapy, 24-hour licensed physician-staffed emergency room, surgical short procedure unit, industrial medicine clinic and pharmacy.

The second of the two hospitals acquired by Metropolitan Hospital was Tri-County Hospital, a 196 bed osteopathic acute care hospital in Springfield Township, a western suburb of Philadelphia. Tri-County provides inpatient acute care services for medical, surgical, pediatric and obstetrics/gynecological patients as well as special care. To support these inpatient services, Tri-County provides various ambulatory and ancillary support services including radiology, laboratory, physical therapy, hemodialysis, speech pathology and emergency room.

There are several reasons that Metropolitan's acquisition was undertaken. Some of the most noteworthy of these include: (i) the consolidation of management and the expansion of management services; (ii) the three hospitals' common osteopathic orientation; (iii) their overlapping service areas and complementary programs and services; and (iv) the admitting practices of the physicians who served on more than one of the three medical staffs.

Another important reason for Metropolitan's acquisition of Tri-County was that it helped meet Metropolitan's pressing needs for additional space for patient services, without resulting in the further expansion of the area-wide health care system. At the time of the bond sale, Metropolitan had been operating at an average annual occupancy level which was in excess of 85 percent, while Parkview's occupancy was nearly 90 percent. A significant number of the patients being admitted to Metropolitan Hospital resided in areas which were as accessible to Tri-County, an underutilized facility at 55 percent occupancy, as they were to Metropolitan. The merger of the three institutions into a single health care system was designed to encourage physicians who typically admitted patients to Metropolitan to admit them instead to Tri-County. The released space at Metropolitan could then be used to provide inpatient services to patients who would have otherwise gone to Parkview, which is located within Metropolitan's service area. With the completion of the bond issue, Metropolitan's management implemented a program to coordinate existing referral patterns, recruit new physicians, and establish new patterns of care at their three separate facilities.

The Metropolitan Hospital financing is indicative of a major trend which is currently evidencing itself in the hospital industry. From state to state, hospitals are merging or acquiring one another to accomplish the objectives of greater operating efficiency, strengthened market positions and increased financial stability.

4. Renovation/Replacement Project With Net Bed Loss, In Major City

Albert Einstein Medical Center, also located in Philadelphia, is another example of a multi-facility hospital system. The Medical Center operates two acute care hospitals, the Northern Division, a 619 bed tertiary care teaching hospital located on a 27 acre campus in northern Philadelphia, and the Daroff Division, a 218 bed community hospital located on a three block site in South Philadelphia. The Medical Center also operates a 102 bed skilled nursing facility and a 137 bed psychiatric care hospital, both of which are located in northern Philadelphia.

In October of 1981, the Medical Center raised over $111,500,000 in capital through tax-exempt bonds sold by the Hospitals Authority of Philadelphia. The financing culminated a nearly five-year planning process which began with the preparation of a long-range master plan in February, 1977. The project financed with the proceeds of the tax-exempt bond issue would replace or renovate virtually all of the patient care facilities at the Medical Center's Northern and Daroff Divisions which, due to age, no longer met contemporary health care standards. The project was also intended to correct existing life safety code deficiencies, to centralize the Medical Center's ambulatory care facilities, and to provide much needed additional parking space.

The primary purpose of the project was to replace the Medical Center's aging physical facilities with modern and efficient facilities with adequate space for the delivery of primary, secondary and tertiary health care services, and for the Medical Center's extensive teaching programs and research activities. Formed in 1952 by the consolidation of hospitals founded in 1866, 1899 and 1925, the Medical Center still relied heavily on many of the buildings originally built for these hospitals. Although periodically renovated, these buildings were insufficient to meet the Medical Center's patient service needs and resulted in significant operating inefficiencies.

The renovation and new construction involved the demolition of buildings at both the Northern and Daroff divisions and the construction of several new buildings at both sites. The new construction at Northern included a nine-level patient tower with 252 patient beds, a five-level ambulatory care center and a multi-level parking garage containing space for approximately 600 cars. New construction at Daroff will include a seven-level, 160 bed patient tower.

After completion of the project, the bed complements of Northern and Daroff would be 600 and 203, respectively, for a total reduction of 34 acute care beds. The combined occupancy of the two Divisions at the end of the construction period was forecasted to be in excess of 87 percent.

The extensive nature of the new construction and renovation to the Medical Center's two Divisional hospital facilities resulted in one of the largest hospital bond issues sold to date. The physical plant improvements were extremely necessary given the age of the existing buildings and the important role of the Medical Center as a regional health service resource. The physical plant problems experienced by the Medical Center are not unique to it. Many providers of health care services, particularly those in urban settings, find themselves utilizing physical plants which are incapable of meeting the demands placed upon them, resulting in costly operating inefficiencies and a loss of quality.

Albert Einstein's role as a major health care provider and teaching and research center is typical of many urban hospitals. Also like many urban hospitals, the institutions and Divisions are major employers within their communities and are important stabilizing factors within their local economies. The Medical Center is also an important provider of outreach services to various groups within the community. This acts to further extend its already important role.

IV. THE IMPACTS OF HOSPITAL TAX-EXEMPT FINANCING

A. Tax-Exempt Financing and Hospital Charges/Financial Position

1. Methodology

The use of tax-exempt bonds has enabled the nation's hospitals to hold down their charges and slow the erosion of their financial position. The replacement of tax-exempt financing by conventional (taxable) financing methods would impose a heavy financial burden on hospitals. The higher interest rates and shorter repayment periods available with taxable financing must manifest themselves by significantly weakening the financial position of hospitals, significantly raising patient charges, or some combination of both of these undesirable consequences.

In order to quantify the magnitude of these effects, the financial characteristics of the prototypical hospital using tax-exempt financing were created from data contained in official statements accompanying 1980 tax-exempt hospital revenue bonds. The data base included 102 issues 13/ out of a total of 294 issued in 1980. These issues accounted for 61 percent of total dollar volume of the tax-exempt hospital revenue bonds brought to market that year. Data regarding these hospitals were grouped into four bond rating classes:

AA+, AA (6 issues);
A+, A (57 issues);
A- (22 issues);
BBB+ and lower (17 issues).

Financial data for a composite hospital in each rating class were developed by combining the data for all hospitals in the sample from that rating class.

It was assumed that if tax-exempt financing were unavailable, hospitals would use taxable bonds to finance capital expenditures. Interest rates for taxable bonds were assumed to be 2 or 5 percentage points higher than tax-exempt rates. Maturities were assumed to be 15 or 25 years, based upon the range of observed financing terms for taxable bonds. Four taxable bond scenarios were developed using the different combinations of these financing terms.

13/ Only tax-exempt revenue bonds for at least $5 million, which were rated by Standard and Poor's or Moody's, and whose official statements contained feasibility studies, were included. Insured bonds were excluded.

2. Hospital Charges

In order to maintain the same financial position with taxable as with tax-exempt financing, hospitals would have to increase their patient charges. Taking debt service coverage 14/ as a key measure of financial position for the composite hospital in each rating class, the charge increases necessary to maintain the same debt service coverage for each taxable bond scenario were calculated. Additionally, debt service coverage for a midpoint scenario for each of the rating classes was calculated, assuming a 3.5 percent interest rate spread with a 20 year maturity.

The results are shown in Table 6.

TABLE 6

SUMMARY OF PERCENTAGE INCREASES IN HOSPITAL CHARGES ATTRIBUTABLE TO TAXABLE FINANCING ALTERNATIVES BY RATING CLASS, ASSUMING DIFFERENT FINANCING TERMS AND CONSTANT DEBT SERVICE COVERAGE RATIOS

	Interest Rate Differentials and Maturities for Taxable Bonds				
Rating Class	+ 2% 25 yrs.	+ 5% 25 yrs.	+ 2% 15 yrs.	+ 5% 15 yrs.	+ 3.5% 20 yrs.
AA+, AA	1.8%	4.0%	4.5%	6.3%	3.6%
A+, A	5.3%	7.2%	8.1%	11.3%	6.6%
A-	4.5%	9.9%	11.7%	16.0%	9.2%
BBB+ and lower	3.8%	8.3%	10.1%	13.7%	7.8%
All Rating Classes	3.5%	7.6%	8.8%	12.1%	7.0%

14/ Debt service coverage was calculated from the financial forecasts for the first year after project completion. Project completion was determined from the financial feasibility studies included in the official statement for each bond issue.

The patient charge increases required to maintain the same debt service coverage for the taxable as for the tax-exempt financing alternatives ranged from 1.8 percent for the highest bond rating class under the most favorable financing scenario to 16 percent for the representative hospital in the A- rating class under the least favorable terms. In general, those hospitals whose financial positions are the weakest, in the estimation of professional bond raters, will have to increase their charges the most in order to maintain their present debt service coverage ratios and financial position. Combining all hospitals in the sample across all rating classes, we find required charge increases ranging between 3.5 percent and 12.1 percent depending upon the interest rate differential and available maturity assumed for the taxable bond alternatives.

The overall weighted average increase in charges for the "mid-point" scenario (3.5 percent rate differential and 20 year maturity) would have been 7.0 percent. Thus, to achieve the same debt service coverage under the greater financial burden of taxable financing, the average hospital would have been forced to increase its patient charges by seven percent if tax-exempt bonds were not available.

3. Hospitals' Financial Position

Should competitive or regulatory constraints prevent hospitals from implementing the full increases in patient charges indicated above, the financial position of the hospital industry, as measured by debt service coverage, would be adversely affected by the elimination of tax-exempt financing. Using the composite hospitals described above, the revised debt service coverage ratios were calculated for each taxable financing scenario, assuming that cost-based payors (i.e., Medicare, Medicaid) reimburse their proportionate share of the higher interest expense associated with taxable financing, but that hospitals' charge structures are not changed.

TABLE 7

SUMMARY COMPARISON OF HOSPITAL DEBT SERVICE
COVERAGES UNDER TAX-EXEMPT AND TAXABLE FINANCING
ALTERNATIVES BY RATING CLASS,
UNDER VARYING FINANCING TERMS

Rating Class	1980 Tax-Exempt Financing Terms	Interest Rate Differentials and Maturities for Taxable Bonds			
		+ 2% 25 yrs.	+ 5% 25 yrs.	+ 2% 15 yrs.	+ 5% 15 yrs.
AA+, AA	3.10x	2.89x	2.67x	2.60x	2.47x
A+, A	2.40x	2.14x	1.91x	1.85x	1.71x
A-	2.00x	1.79x	1.59x	1.51x	1.41x
BBB+	1.68x	1.51x	1.37x	1.30x	1.22x

For all taxable financing scenarios except the one with the most favorable terms (2% rate differential; 25 year maturity), the debt service coverage ratio drops to such an extent that the rating for the hospitals concerned would be expected to fall by one rating class. Such a drop would adversely affect the interest rates which would have to be paid for taxable financing, increasing the interest rate differential and further exacerbating the effects on financial position. In addition, since the debt service coverages for bonds in each of the rating classes fall into a range, of which only the average is shown in Table 7, the financial position of a significant portion of the hospitals involved would be expected to be worse than the averages shown, without large charge increases.

Abolition of tax-exempt financing would also deprive a significant number of hospitals of access to the private capital market. As Table 8 shows, 35 percent of hospital tax-exempt issues are rated A- or below. With elimination of tax-exempt financing, these hospitals would drop one rating class as noted above. This means that 35 percent of the hospitals seeking to use the private long-term capital market would be rated BBB or lower. Yet, in today's market, an A- rating or better is the absolute minimum for long-term taxable financing, even though BBB rated hospitals can use tax-exempt debt. The net result, then, of eliminating tax-exempt financing would be to bar over one-third of the otherwise eligible hospitals from access to the private capital market.

TABLE 8

DISTRIBUTION
OF RATINGS OF HOSPITAL
TAX-EXEMPT REVENUE BONDS[15]

Rating	Percentage
AA or better	3%
A+, A	62
A-	15
BBB+ or below	20
	100%

A second approach to assessing the impact of the elimination of tax-exempt bonds on the financial position of hospitals examined the effects of the substitution of taxable for tax-exempt financing on hospital reserves and equity, again assuming no additional charge increases. Using the representative A+/A rated hospital previously described, the effects of the alternative debt service schedules associated with taxable financing on annual cash flows and investment income were computed. As can be seen in Table 9, the cumulative adverse effect on cash for the representative A+/A rated hospital ranged from $56.5 to $318.4 million over the term of the borrowing depending on the financing terms of the taxable bonds.

15/ Condon, William P., "Hospital Revenue Bonds -- How They're Rated," Hospital Financial Management (September, 1981), at 62.

TABLE 9

AN ANALYSIS COMPARING THE INCREMENTAL CASH OUT-FLOW RESULTING WHEN A $20 MILLION TAXABLE A+/A RATED BOND, UNDER VARYING FINANCING TERMS, IS SUBSTITUTED FOR A $20 MILLION A+/A RATED TAX-EXEMPT BOND [16/]

(In Millions)

	Interest Rate Differentials And Maturities for Taxable Bonds			
A+/A Rated Bonds	Tax-Exempt + 2% 25 yrs.	Tax-Exempt + 5% 25 yrs.	Tax-Exempt + 2% 15 yrs.	Tax-Exempt + 5% 15 yrs.
Cumulative Net Cash Outflow at Maturity	$56.5	$216.0	$109.4	$318.4
Net Present Value in 1980 $ of Cumulative Net Cash Outflow*	$2.0	$3.6	$3.9	$5.3
Percentage Reduction in Equity	7.8%	13.9%	15.0%	20.3%

In 1980 dollars, the adverse effect ranged from $2.0 to $5.3 million per hospital representing between 7.8 percent and 20.3 percent of the total equity for the representative hospital.

4. Summary

The findings indicate that financing debt through taxable instruments will result in a substantial decrease in cash available for investment or working capital (everything else unchanged), due to both the higher interest rates and the

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[16/] Note: The dollar amounts in Table 9 are predicated on a bond issue of $20,007,000.

*Net present value based on discount rate equal to assumed taxable borrowing rate for each scenario.

accelerated principal repayment associated with the shorter maturities. The effects of the annual reductions in cash reserves will be compounded by the additional loss of investment earnings. The slower growth in equity will lead to higher debt-to-equity ratios, less available working capital and the potential erosion of hospital endowments. As studies have already indicated, the return on equity of hospitals is not keeping pace with inflation and service requirements. The further deterioration of equity growth will only magnify this problem. Financing will become increasingly difficult for hospitals due to their impaired financial position.

Thus, the elimination of tax-exempt financing for hospitals will result in higher charges or a weakened financial position, or a combination of both, for those hospitals which are able to arrange alternative conventional financing. The average hospital will have to increase its charges in the neighborhood of seven percent just to maintain the same coverage of its higher debt service requirements. To the extent that such increases are not possible, due to competitive or regulatory constraints, those hospitals would suffer a diminution in their cash flow and financial position, with an across-the-board drop of one bond rating category for hospitals. Projected debt service coverage for the 1980 issues included in our sample would decrease to the point where perhaps one-third of the hospitals would not have been able to market their debt.

B. Tax-Exempt Financing and Hospital Construction

Some critics of tax-exempt hospital financing have maintained that the availability of tax-exempt bonds has spurred hospital construction. Data from the Congressional Budget Office indicate that between 1971 and 1980 the annual volume of tax-exempt hospital bonds issued increased over 580 percent in constant dollars. During the same period of time, Table 10 shows that the total volume of hospital construction projects completed decreased some 34 percent in constant dollars. In other words, the relevant statistics show an inverse relationship between the volume of tax-exempt hospital bonds issued and hospital construction completed.

TABLE 10

TAX-EXEMPT HOSPITAL BONDS ISSUED VS. HOSPITAL CONSTRUCTION COMPLETED, 1971, 1980, IN CONSTANT (1967) DOLLARS (Millions) 17/

	Tax-Exempt Hospital Bonds Issued	Hospital Construction Completed
1971	$ 216	$2,872
1980	$1,468	$1,883
Change 1971-1980	up 580%	down 34%

It is important to note that construction financed by tax-exempt hospital bonds often does not result in an increased number of hospital beds. In 1980, for example, 60 percent of the dollar volume and 65 percent of the number of all hospital tax-exempt bond financings resulted in no increase in bed complement. Similarly, for the first six months of 1981, nearly 45 percent of the dollar volume and 45 percent of the number of hospital financings did not result in net new beds. 18/

Federal health planning experts have acknowledged that hospital construction does not necessarily lead to a large growth in the bed supply or to the creation of unneeded beds. The Department of Health and Human Services has estimated that the net increase in hospital beds for the year 1979 was between 0.2 percent and 0.4 percent. 19/ This level is well below the increase in the country's population. It is simply not the case that hospitals use tax-exempt bonds to finance unneeded additions to the nation's supply of hospital beds.

17/ (a) For tax-exempt hospital bonds issued: CBO Report, Table 7, at 49 (figures adjusted for growth in Consumer Price Index); and (b) For hospital construction completed: Bureau of Census figures.

18/ See Appendix B for further discussion.

19/ See, *e.g.*, Bureau of Health Planning (HEW), Program Information Letter 80-18, "Data Highlights from State Reports on Hospital Capital Expenditures," December 27, 1979. This government document shows that the rate of increase in the nation's hospital bed count has plummeted in recent years, from 2.1 percent in 1973 to an estimated range of 0.2 to 0.4 percent for 1979.

C. Hospital Tax-Exempt Bonds and the Federal Budget

Tax-exempt hospital bonds have been accused of creating a drain on the federal Treasury and thus adding to the chronic imbalance of the federal budget. 20/ The HCFSG finds this charge unsupportable, for the following reasons:

-- Estimates of federal tax revenue losses caused by hospital tax-exempt bonds are unrealistic and inflated.

-- The bonds have actually saved the Treasury significant amounts by reducing hospitals' interest expenses, thus cutting Medicare and Medicaid reimbursement for these costs.

-- The contention that hospital bonds drive up the cost of borrowing for governments and other issuers of tax-exempt bonds is seriously exaggerated.

-- The bonds stimulate the creation of jobs and additional federal tax revenues. The use of taxable bonds would reduce this stimulus somewhat, since the higher taxable interest rates would force hospitals to issue a smaller volume of bonds.

On balance, tax-exempt hospital bonds cost the federal government very little, if anything; they may even save the Treasury money when all factors are considered.

1. Tax Revenue Losses

The Congressional Budget Office (CBO) is the principal source for estimates of the tax revenue losses caused by tax-exempt hospital bonds. The CBO contends that the bonds cost the Treasury $400 million in foregone tax revenues during fiscal year 1980. 21/ This estimate is based upon an assumption about the bond market that has been roundly criticized. CBO assumes that tax-exempt financing displaces primarily taxable financing from other sources rather than consumption, saving, or other tax-exempt financing. CBO contends that when tax-exempt financing is introduced into the market, it causes a "chain reaction" among investors: each investor moves down a rung on the ladder of securities ranging from fully taxed to tax-exempt. Although no individual investor moves directly from tax-exempt to fully taxable investments, CBO argues that the net result is equivalent to having tax-exempt issues displace fully taxable ones in the market.

20/ CBO Report, at 47-48.

21/ *Id.*

CBO's "chain reaction" scenario has been widely disputed. CBO errs in assuming that investors select their portfolios of assets based entirely upon consideration of the tax treatment of those assets. 22/ Such an assumption is inconsistent with the facts of actual asset holdings in the economy and with widely accepted and empirically verified portfolio theory. Investors consider possible risks and returns associated with their investments, not just the tax treatment of the assets. The CBO scenario naively assumes that risk and return considerations are inconsequential to investors.

Certain types of investors do not hold certain types of investments exclusively, as the CBO scenario would lead one to expect. Federal Reserve Board data show that there is some tendency for larger holdings of tax-exempt bonds by high income investors and larger holdings of taxable bonds by low income investors. However, households in all income classes hold corporate equity in similar amounts. 23/ The CBO view of asset holdings is simply indefensible in light of the actual data. 24/ CBO's unrealistic view of investor behavior causes it to overestimate tax revenue losses by a factor of 6 or 7. 25/ Thus, the direct tax revenue loss caused by tax-exempt hospital bonds may be $60 to $70 million in fiscal year 1980 -- not $400 million.

22/ Kormendi, Roger C. and Thomas T. Nagle, "A Critique of the CBO Estimates on the Federal Revenue Losses from Industrial Development Bonds," unpublished paper, 1981, at 2-6.

23/ Kormendi and Nagle, at 2-7.

24/ Dr. Norman Ture, Treasury Under Secretary for Tax and Economic Affairs, also faults CBO's tax revenue loss estimate. In his 1980 unpublished paper, "Economic and Federal Revenue Effects of Changes in the Small-Issue IDB Provision," at 11-12, his analysis of the CBO estimate is similar to that of Professors Kormendi and Nagle. Ture also criticizes CBO's "unrealistic assumption" that new tax-exempt bonds displace taxable bonds.

25/ See Kormendi and Nagle. For a discussion of, *inter alia*, the impact which investor behavior and expectations may have on tax-exempt hospital bond rates during 1982, see Mansdorf, Bruce D., Joseph R. Marion, and Alex Rorke, "Bond Market Forecasting: What Can Hospitals Expect in 1982 Financial Market?" *Hospital Financial Management* (January, 1982), at 34-43.

2. Medicare/Medicaid Savings

Hospital tax-exempt bonds provide substantial savings to the Medicare and Medicaid programs through reduced reimbursement for hospitals' interest expenses. By using tax-exempt rather than taxable bonds, hospitals are able to reduce the interest rate they must pay on their debt. This cuts interest expenses significantly.

These interest expense reimbursement savings can be seen by looking at new issues during the last several years. As Tables 11 and 12 show, the average net interest cost for hospital bonds would have been approximately five percentage points higher during 1979, 1980 and the first half of 1981 if the bonds had been taxable rather than tax-exempt. As Table 13 shows, these higher interest rates would have raised hospitals' interest costs on new bond issues by $149 million in 1979, $189 million in 1980, and $128 million in the first half of 1981. 26/

TABLE 11

Aaa TO Baa RATED MUNICIPAL BOND YIELDS AND NET INTEREST COST OF TAX-EXEMPT HOSPITAL ISSUES, 1979-1981(1)

Year	Aaa Issues	Aa Issues	A Issues	Baa Issues	Hospital Issues
1979	5.92%	6.12%	6.34%	6.73%	7.71%
1980	7.84%	8.06%	8.44%	9.00%	9.69%
1981(2)	9.58%	9.93%	10.26%	10.63%	11.70%

Notes:

(1) Averages from Moody's Bond Record and The Daily Bond Buyer. Average NIC was calculated for hospital revenue bond issues over $5 million only.

(2) First six months.

26/ See Appendix C for further discussion of the derivation of Tables 11 through 13.

TABLE 12

AVERAGE CORPORATE BOND YIELDS AND HYPOTHETICAL NET INTEREST COST OF TAXABLE HOSPITAL ISSUES, 1979-1981(1)

Year	Aaa Issues	Aa Issues	A Issues	Baa Issues	Hospital Issues
1979	9.63%	9.94%	10.20%	10.69%	12.44%
1980	11.94%	12.50%	12.89%	13.67%	14.91%
1981(2)	13.57%	14.17%	14.65%	15.51%	16.71%

Notes:

(1) Assumes tax-exempt yields are 62% of comparable taxable yields in 1979, 65% in 1980, and 70% in 1981, according to recent historical experience.

(2) First six months.

TABLE 13

ADDITIONAL INTEREST COSTS OF TAXABLE VS. TAX-EXEMPT HOSPITAL BONDS, 1979-1981 (In Millions)

Year	Hospital Tax-Exempts Issued(1)	Tax-Exempt Interest Payments(2)	Interest Payments if Taxable (2)	Additional Interest Cost
1979	$3,154	$243	$392	$149
1980	$3,624	$351	$540	$189
1981(3)	$2,562	$299	$428	$128

Notes:

(1) For 1979, CBO Report; for 1980, Public Securities Association; for 1981, Daily Bond Buyer.

(2) Assumes interest rates in Table 11 for tax-exempt hospital issues and in Table 12 for taxable hospital issues.

(3) Six month data.

Medicare and Medicaid reimburse hospitals for approximately 35 to 40 percent of all expenses, including interest costs. 27/ To make a conservative estimate, the federal government, through Medicare and Medicaid, saved approximately one-third of hospitals' total interest savings on new issues during these years -- roughly $50 million in 1979, $63 million in 1980, and $42 million in the first half of 1981. Thus, the use of tax-exempt bonds by the nation's hospitals saved the Treasury a total of $155 million in reduced Medicare and Medicaid reimbursement for interest expenses in just the first year's interest payments on new bonds issued in 1979, 1980 and the first six months of 1981.

It is instructive to consider the savings the Treasury derives from reduced interest payments on all outstanding hospital bonds during a single year -- 1980. CBO estimates that by 1980 $15.4 billion in tax-exempt hospital bonds were outstanding. 28/ Although interest rates have varied during the years these bonds were issued, these rates would have been higher if they had not been tax-exempt. A conservative estimate would be that taxable interest rates have averaged approximately three percentage points more than tax-exempt rates. 29/ Thus, hospitals saved three percent of the $15.4 billion in outstanding bonds in interest expenses during 1980 alone -- approximately $460 million. The federal government's share of these savings (through reduced Medicare and Medicaid interest expense reimbursement) is at least one-third of the total, or over $150 million. One should note, too, that when tax-exempt rather than taxable bonds are used, the savings, for both hospitals and for the federal government, increase as: (1) the capital spending financed by bonds rises; and (2) the interest rate differential between taxable and tax-exempt bonds increases.

In sum, the Treasury saved over $150 million in 1980 due to hospitals' interest savings on outstanding debt derived from the use of tax-exempt bonds. Further, the use of tax-exempt hospital bonds saved the Treasury $60 million in interest reimbursement for new issues during 1980. It is important to note that this $60 million in savings on the 1980 issues is an annual figure. Over an assumed 25-year life of the 1980 issues,

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27/ Gibson, Robert M. and Daniel R. Waldo, "National Health Expenditures, 1980," in Health Care Financing Review (September, 1981), Table 7A, at 48.

28/ CBO Report, at 47.

29/ See Appendix C.

these savings grow much larger. 30/ If the tax-exempt hospital bonds issued in 1980 had been issued taxably, the cumulative additional interest costs to maturity would be approximately $4 billion. 31/ Under the present Medicare and Medicaid reimbursement system, the federal government would reimburse hospitals at least one-third of this amount -- over $1.3 billion.

3. Other Interest Rates

CBO and other critics of tax-exempt hospital bonds contend that these bonds crowd the market place and drive up interest rates for all issuers of bonds, including governmental issuers. CBO estimates that for every $1 billion in new tax-exempt bonds introduced in the market, interest rates rise five to seven basis points. This CBO estimate has been vigorously disputed. 32/ When the effects of inflation, lagged portfolio adjustments, and the integrated structure of the capital markets are taken into account, each $1 billion in new tax-exempt financing leads to a rise in interest rates of only 0.6 basis points. 33/ This estimate is approximately one-tenth that of the CBO. Whether tax-exempt hospital bonds actually drive up other interest rates, and how much this costs local, state and federal governments, is beyond the scope of this study. It should be underscored that tax-exempt hospital bonds make up a small portion, i.e., approximately one tenth, of the tax-exempt bond market. Therefore, it is difficult to believe that hospital tax-exempt bonds exert a major impact on credit markets or interest

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30/ The estimate is, if anything, conservative. The average life of hospital tax-exempt bonds issued today is closer to 30 years.

31/ In 1980, almost $3.6 billion in tax-exempt hospital bonds were issued at an average net interest cost of 9.69%, representing $341 million in interest payments the first year. Had the bonds been taxable, annual interest payments would have been $525 million, an additional cost of $184 million that year. Over the average bond life of 25 years, the cumulative additional interest costs to maturity would be $4.0 billion. See Appendix C.

32/ Kormendi and Nagle, "A Summary of the Nature and Effects of Small-Issue IDBs," unpublished paper, 1981, at 3.

33/ Kormendi and Nagle, "The Interest Rate and Tax Revenue Effects of Mortgage Revenue Bonds," unpublished paper, 1980, at 10-11.

rates. It is sufficient to state that some economists regard CBO's estimate as unacceptably large. 34/

4. "Reflow Effects"

Tax-exempt hospital bonds have "reflow effects" which benefit the federal treasury. Tax-exempt hospital bonds allow hospitals to grow and expand. They stimulate the creation of new jobs, lead to increased sales of supplies and equipment, and generate increased economic activity in other ways as well. This, in turn, results in additional tax revenues for local, state, and federal governments.

The precise amount of the additional tax revenue generated by a given amount of tax-exempt hospital financing is difficult to quantify. However, it is significant that researchers have found that small-issue tax-exempt IDBs generate net gains in tax revenues for federal, state, and local governments as the restrictions on their volume are relaxed. 35/ While it is beyond the scope of this study to estimate similar reflow effects for hospital tax-exempt bonds, they clearly exist, and must be considered in any calculation of how tax-exempt hospital bonds impact the Treasury.

5. Summary

While the impacts of the use of tax-exempt bonds by hospitals upon the federal Treasury are difficult to estimate with precision, we believe that the evidence supports a figure far lower than that given by the CBO. First, the CBO's estimate of $400 million in fiscal 1980 for direct tax revenue losses caused by the bonds is highly exaggerated. A figure of $60 to $70 million appears to be much closer to the mark. Second, the CBO failed to consider the significant savings in Medicare and Medicaid interest expense reimbursement realized as a result of the use of tax-exempt hospital bonds. These savings are at least $150 million during fiscal 1980, a figure which would more than cancel out the small direct tax revenue losses. Third, CBO overestimated -- perhaps by as much as a factor of ten -- the impact of new tax-exempt bond issues on the overall tax-exempt interest rate. Finally, the CBO neglected to consider the

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34/ Kormendi and Nagle, "A Summary of the Nature and Effects of Small-Issue IDBs," at 3-4.

35/ Norman B. Ture, "Economic and Federal Revenue Effects of Changes in the Small-Issue IDB Provision," unpublished paper, 1980, at 11-12.

increased tax revenues which result from the capital investments made by hospitals using tax-exempt bonds. In short, the contention that hospital tax-exempt bonds cost the Treasury money has not been adequately proven. It is not going too far to say that these bonds can save the Treasury money over the long run.

V. THE FUTURE OF HOSPITAL TAX-EXEMPT FINANCING

The 1980s shape up as a decade during which the hospital sector will exert an unprecedented demand for capital. The hospital financial community is nearly unanimous in pointing to capital formation as the crucial issue for hospital survival during the next ten years. 36/ Capital will be needed in large amounts for the maintenance of facilities, and for the renovation and replacement of worn-out physical plants. Large infusions of capital will also be needed to accomplish an absolutely essential organizational transformation of the industry. In one of its dimensions, this organizational transformation will take the form of consolidation into more efficient units. In another, equally important dimension, it will take the form of new patterns in the delivery of care, as exemplified by increasing resort to ambulatory care in outlying facilities. Both institutional consolidation and construction of new ambulatory care facilities will require capital. In addition, as in any other industry undergoing structural change, the individual hospital will require access to sufficient working capital to absorb the shock of adjusting to the industry's new structure.

The growing need for hospital capital has been documented by several sources. For example, one hospital investment banking group has projected a need for no less than $190 billion in capital between now and 1990, merely to maintain the existing hospital plant. 37/ Even if the industry's bed count were reduced 15 percent (a rather unattainable goal), there would still be a need for $158 billion in capital spending. 38/ Some of this capital will be required to develop the infrastructure for new, more efficient modes of health care delivery. The federal government itself seems to agree with this perception of a major new need for hospital capital. HHS's Bureau of Health Facilities has made a conservative estimate that the demand for hospital capital will reach $120 to $158 billion. 39/ These

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36/ See, *e.g.*, Frank, Frederick and Michael Patrick George, "Capital Management: Funding Strategy Among Multi-Hospital Systems," *Hospital Financial Management* (September, 1981), at 24-32.

37/ Hernandez, Michael D., "The Capital Structure of the Hospital Industry in the 80s," Kidder, Peabody & Co., Inc., June, 1981.

38/ *Id.*

39/ "Briefing on Capital Issues," Bureau of Health Facilities, Department of Health and Human Services, January 14, 1981.

figures are double and perhaps triple the levels of hospital investment required during the 1970s. 40/

It is one thing to state that the hospital industry needs $150 to $190 billion in capital during the 1980s. It is another thing for this need actually to be met. A number of factors can prevent a hospital from acquiring all the capital it needs. These factors include: (1) the inability of some institutions, because of poor financial condition and low credit ratings, to gain access to the private capital market; (2) negative decisions by health planning agencies; (3) limitations on the availability of mortgage insurance programs (e.g., FHA § 242 program) for hospitals which need them; and (4) external market conditions, such as high interest rates, which act to depress the volume of hospital capital financing.

In fact, it is difficult to project the volume of hospital tax-exempt financing which will actually occur during the 1980s. Table 1 and Chart 1 illustrated the growth in issuance of these bonds since 1971. 41/ Hospital tax-exempt bonds appear to have reached maturity as a financial product during the mid-1970s. Since then, with the exception of the bulge of refinancings during 1977, growth has been steady, but unspectacular. In fact, when the volume of tax-exempt hospital issues is discounted for inflation, it is hardly growing at all.

If, on the other hand, tax-exempt bonds were eliminated as a long-term capital financing alternative for hospitals, there would be a series of undesirable consequences. First, if hospitals' financial positions remained constant, as indicated in Section IV A above, hospital charges and/or costs would rise by seven percent. The result would be an unwanted further addition to the nation's health care bill and to the overall rate of inflation. Second, if hospital costs and charges remained constant, as indicated in Section IV B above, there would be a further and serious deterioration of hospitals' financial condition. Specifically, hospitals would incur a higher debt-to-equity ratio, would have less funds available for investment as working capital, and would experience a decline in investment earnings, for example, in income earned on funded depreciation accounts. These deteriorating financial conditions would be reflected in a drop of one rating class for all but the most secure hospitals. The ranks of hospitals which are rated BBB+ or lower would swell, and these hospitals would find it difficult or impossible to gain access to the private capital market at all. Actually, of course, a combination of both of these effects would

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40/ Id.

41/ See above, pp. 3, 5.

occur to a degree: some hospitals' charges would rise, some hospitals' financial positions would deteriorate, and some hospitals would be barred from the private capital market altogether.

Here we have touched on the most severe impact of the potential elimination of hospital tax-exempt bonds. Such a move would accelerate a trend which is already visible, the division of the hospital sector into a small class of "haves" and a large class of "have-nots." The class of hospitals which are eligible for tax-exempt financing is substantially larger than the class of hospitals which are eligible for taxable bond financing. Although exceptions can be made in particular cases, a hospital must generally be A- rated or better to be able to sell taxable bonds at market prices. Significantly, at the present time, only 65 percent of the nation's tax-exempt hospital bonds are in this rating category. 42/ Thus, over one-third of all tax-exempt hospital bonds sold today could not find buyers if they were taxable bonds instead. It seems clear that abolition of hospital tax-exempt financing would bar many hospitals from the capital market.

Barring a significant percentage of the nation's hospitals from the private capital market is a move with serious consequences, and should be considered very carefully by legislative policy makers. The fact that these hospitals are barred from the private capital market will not in any way hinder their growing and very real need for capital. As a result, they are likely to turn to what has emerged as the functional equivalent of the lender of last resort for hospitals, i.e., various programs of federal loan insurance for hospitals. Programs such as that under FHA § 242, which are struggling now to accommodate demands which have been placed on them, would be further strained, perhaps to the breaking point.

The abolition of hospital tax-exempt bonds will also seriously cripple the industry's ability to transform itself into a deregulatory and pro-competitive posture. Horizontal integration, new institutional arrangements, and new modes of patient care will all require major inputs of capital. To hinder hospitals' access to private capital is to retard that very transformation of the industry which is widely predicted and sought by the current health policy consensus in Washington.

42/ Condon, William P., "Hospital Revenue Bonds -- How They're Rated," Hospital Financial Management (September, 1981), at 62.

VI. CONCLUSIONS

The use of tax-exempt hospital bonds, which grew rapidly during the early and mid-1970s, has settled into a pattern of slow growth in recent years.

> During the early and mid-1970s, the use of tax-exempt bonds to finance hospital capital projects jumped, primarily for two reasons. First, other sources of capital funding, such as government grants and philanthropy, shrank markedly. Second, the legal mechanisms required to sell the bonds, such as public bond authorities, were not set up in many areas until the 1970s. In recent years, bond use has increased at a much slower pace than in the past, particularly when measured in constant dollars.

While construction is the most important use of tax-exempt capital by hospitals, other uses are important.

> "Project costs" (i.e., construction, equipment, and architectural and engineering fees) consumed between 60 and 65 percent of the funds raised by hospitals through tax-exempt bonds during recent years. Refinancing of prior debt and the investor-required debt service reserve each accounted for 10 percent of the funds. Capitalized construction-period interest accounted for an additional 13 percent of the funds. Transaction costs (*i.e.*, legal fees, printing, feasibility study, bond discount) are less than 5 percent of the total.

Tax-exempt bonds play an important role in helping hospitals hold down costs.

> If hospitals had been unable to utilize tax-exempt financing, their costs and charges would have increased by an average of 7 percent over current levels, unless they allowed their financial positions to decline. This increase would contribute to inflation and would have an adverse impact on the federal budget through the Medicare/Medicaid reimbursement system and through inflation-indexed transfer payments.

Tax-exempt bonds have been instrumental in helping hospitals maintain their financial position.

> Without the use of tax-exempt bonds, the financial position of many of the nation's hospitals would deteriorate, unless charges were increased significantly. If taxable bonds were used instead of tax-exempt bonds to finance hospital capital projects, debt service coverage ratios would drop for most hospitals, resulting in a bond rating drop of one rating class. Taxable bond use would also lead to higher debt-to-equity ratios, less available working capital, and potential erosion of hospital endowments -- all leading to a weaker financial position for hospitals.

The growth of hospital tax-exempt financing has not led to a boom in hospital construction and the addition of new beds.

> While the volume of tax-exempt hospital bonds issued increased nearly 580 percent in constant dollars between 1971 and 1980, the volume of hospital construction fell by 34 percent in constant dollar terms during the same period. The supply of hospital beds, moreover, is growing very slowly, if at all.

Tax-exempt hospital bonds cost the federal government very little, if anything; they may even be net revenue producers for the Treasury.

> Current governmental estimates of direct tax revenue losses caused by hospital bonds are based upon unrealistic assumptions and are seriously inflated. The estimate of the Congressional Budget Office that hospital bonds resulted in $400 million in tax revenues lost during 1980, appears to be overstated by a factor of 6 or 7. In contrast, hospital tax-exempt bonds save the federal government large sums by reducing hospitals' interest expenses, thus cutting Medicare and Medicaid reimbursement for these costs. During 1980, these Medicare/Medicaid savings appear to have been at least $150 million. In addition, the bonds stimulate the creation of jobs, new economic activity, and additional tax revenues. On balance,

> tax-exempt hospital bonds may actually save the Treasury money when all factors are considered.

Tax-exempt bonds are needed to play a vital role in the future capital financing plans of the nation's hospitals.

> During the decade of the 1980s, capital formation will be crucial to the survival of the nation's hospitals. Yet, elimination of tax-exempt financing would bar one-third of the nation's hospitals from access to the private capital market. The need for secure access to capital will be great as hospitals face the challenges ahead, and tax-exempt bonds will play an important role in providing the capital needed by hospitals.

APPENDIX A: Tax-Exempt Hospital Issues and the Municipal Bond Market

According to the Public Securities Association (PSA), the municipal industry brought a record $74.3 billion of short- and long-term new issues to market during 1980, a 22 percent increase over the $61.0 billion issued during 1977. Over the four year period, the number of issues brought to market in 1980 represents an 8.0 percent increase over the number of issues and a 22 percent increase over the dollar volume of issues brought to market in 1977. (See Table A-1.)

The year 1980 saw $46.6 billion of long-term municipal debt issued, a 28.7 percent advance over 1977's $36.2 billion. Primarily reflecting the uncertain interest rate environment, new issues of short-term debt (due within one year) set a record of $27.7 billion during 1980. During the 1977-1980 period, short-term tax-exempt offerings advanced 12 percent in volume while the number of issues declined 21.2 percent. (See Table A-1.) PSA does not separately identify short-term hospital offerings. In addition to the $46.6 billion of municipal bonds for new capital in 1980, an additional $1.8 billion of municipal issues refinanced outstanding debt.

Table A-2 presents a detailed breakdown of new capital municipal issues by their use of proceeds for the period 1977-1980. Although the dollar volume of all long-term municipal bond offerings for new capital increased by 28.7 percent from 1977 to 1980, offerings on the hospital bond market increased by only 8.9 percent during the same period. This relatively small increase in the dollar volume of health care issues, compared to the growth in municipal issues in general, resulted in health care issues actually declining, as a proportion of the total of long-term municipal bond issues for new capital, by 1.4 percentage points. For 1980, health care's 7.8 percent share of the municipal bond is down from its 1977 share of 9.2 percent. (See Tables A-3 and A-4.) But note that health care's share of the market rose to 11 percent for 1981. (See text p. 9.)

TABLE A-1

NEW CAPITAL
TAX-EXEMPT MARKET SUMMARY, 1977-1980
(Amounts in Thousands)

Long-Term Issues

Year	Total Amount	Total Number
1980	$46,599,590	7,151
1979	41,410,324	6,723
1978	37,428,172	6,347
1977	36,233,030	5,795

Short-Term Issues

Year	Total Amount	Total Number
1980	$27,719,623	2,344
1970	21,715,208	2,077
1978	21,383,806	2,336
1977	24,750,851	2,975

Grand Total

Year	Total Amount	Total Number
1980	$74,319,213	9,495
1979	63,125,532	8,800
1978	58,811,978	8,683
1977	60,983,881	8,770

Source: Public Securities Association

TABLE A-2

NEW CAPITAL
MUNICIPAL BOND VOLUME, 1977-1980
BY
USE OF PROCEEDS
(Amounts in Thousands)

	1977		1978	
Use of Proceeds	Amount	Number	Amount	Number
Elementary and Secondary Ed.	3,360,121	1,178	3,223,513	1,101
Colleges & University	1,294,920	144	1,135,910	142
Other Education	398,482	101	613,263	88
Roads, Bridges	1,563,570	284	1,332,321	351
Ports, Airports	920,391	81	1,497,152	102
Other Transportation	485,494	53	628,906	82
Pollution Control	409,863	22	451,045	23
Water & Sewer	3,324,244	1,097	3,246,873	1,296
Electric & Gas	3,364,721	128	4,452,321	132
Other Utilities & Conserv.	1,010,061	114	868,212	90
Public Housing	3,760,262	236	5,630,493	369
Hospitals	3,329,836	466	2,301,167	502
Other Social Welfare	783,630	27	1,796,905	87
Industrial Aid Other	2,069,074	339	853,425	443
Industrial Aid Pollut. Control	2,627,715	234	1,624,785	205
Public Services	690,786	194	547,598	257
Recreation	479,220	125	683,167	163
Classified Misc.	755,373	137	390,744	77
Various Purp. Unknown	5,605,267	855	5,150,372	837
Total New Capital	36,233,030	5,795	37,428,172	6,347

Source: Public Securities Association

TABLE A-2
Continued

NEW CAPITAL
MUNICIPAL BOND VOLUME, 1977-1980
BY
USE OF PROCEEDS
(Amounts in Thousands)

	1979		1980	
Use of Proceeds	Amount	Number	Amount	Number
Elementary and Secondary Ed.	2,834,581	1,052	3,178,763	987
Colleges & University	1,769,761	158	1,042,674	106
Other Education	553,659	89	350,756	45
Roads, Bridges	1,128,187	292	1,085,760	301
Ports, Airports	857,435	83	883,284	82
Other Transportation	435,491	36	654,695	78
Pollution Control	659,285	39	569,430	31
Water & Sewer	3,160,087	1,001	2,929,633	973
Electric & Gas	3,479,690	146	3,438,522	154
Other Utilities & Conserv.	1,208,971	110	1,083,497	110
Public Housing	12,123,556	729	15,480,778	1,078
Hospitals	3,444,287	563	3,624,054	662
Other Social Welfare	124,465	25	266,475	45
Industrial Aid Other	1,720,250	800	1,704,324	746
Industrial Aid Pollut. Control	2,088,730	193	2,270,954	262
Public Services	481,577	184	777,293	160
Recreation	501,770	105	580,309	105
Classified Misc.	19,050	15	338,116	100
Various Purp. Unknown	4,819,492	1,103	6,340,273	1,126
Total New Capital	41,410,324	6,723	46,599,590	7,151

Source: Public Securities Association

TABLE A-3

1977-1980
PERCENT CHANGE
HEALTH CARE VOLUME
TO
MUNICIPAL BOND VOLUME
(Amounts in Thousands)

Use of Proceeds	1980	1977	$ Amount Change 1977-1980	Percent Change
Hospitals	$ 3,624,054	$ 3,329,836	$ 294,218	8.9%
Total Municipal New Capital	46,599,590	36,233,030	10,366,560	28.6

Source: Public Securities Association

TABLE A-4

1977-1980
HEALTH CARE VOLUME
AS A PERCENT OF
MUNICIPAL BOND VOLUME
(Amounts in Thousands)

Use of Proceeds	1980	1977
Hospitals	$ 3,624,054	$ 3,329,836
Total Municipal New Capital	46,599,590	36,233,030
Health Care Percentage of Total	7.8%	9.2%

Source: Public Securities Association

APPENDIX B: How Hospitals Use Tax-Exempt Bonds

In order to determine how hospitals actually use the money raised from the sale of tax-exempt bonds, an analysis was conducted on a sample of bond issues for the calendar year 1980 and the first six months of 1981.

Definition of Sample

The initial problem in any study of this type is the proper selection of a sample from the universe of issues. In order to define this "universe of issues," two independent industry sources were used: The Public Securities Association and The Daily Bond Buyer. From each of these sources a tabulation of health care issues was obtained for the calendar year 1980 and the first six months of 1981. In order to focus on bond issues of sufficient magnitude, this tabulation was reduced to a universe of issues containing bond proceeds of $5 million and over. This list contained 194 hospital bond issues for calendar year 1980 and 113 issues for the first six months of 1981. (See Table B-1.)

From this list of hospital bond issues, certain issues over $5 million were excluded from the study because they represented GNMA, FHA, HEW, Hill-Burton Collateralized, or General Obligation Bond Issues. Also, certain issues were excluded because their use of proceeds included Life-Care Centers, Nursing Homes, For-Profit Institutions, or Mental Health Facilities. This resulted in the exclusion of 36 issues for 1980 and 17 issues for 1981. In addition, there were 29 official statements for calendar year 1980 and 24 official statements for the first six months of 1981 that were not available at the time of the study. This means that the 1980 study sample consists of 129 bond issues representing 66.5 percent of the total number of issues (194) and 68.8 percent of the total dollar volume of issues ($3,458,241). Similarly, the 1981 study sample consists of 72 bond issues representing 63.7 percent of the total number of issues (113) and 64.3 percent of the total dollar volume of issues ($2,550,375). (See Table B-2.)

According to our sample, the financing of construction costs, as reported in the "Sources and Uses of Funds" table in the official statement, represents the most significant use of bond proceeds. In 1980, 54.02 percent of all funds used were allocated for construction. In 1981, construction costs accounted for 52.22 percent of all funds used. If architectural fees, engineering fees, and equipment costs are included, the 1980 percentage rises to 65.14 percent of all funds used. The corresponding 1981 percentage rises to 59.54 percent. For both 1980 and 1981, equipment costs were between 4 and 7 percent of all funds used. These figures may be greatly understated due to the absence of a detailed breakdown of project costs. For example, fixed equipment costs are often incorporated in construction costs.

In both 1980 and 1981, the debt service reserve fund accounted for 9-10 percent of the funds, while the capitalized construction-period interest fund was in the 13-14 percent range. The refinancing of outstanding debt represented 9.21 percent of all funds used in 1980. In 1981, refinancings represented 10.84 percent of all funds used. Finally, the transaction costs of issuance fees (legal, printing, accounting, etc.) and bond discount claimed less than 5 percent of the funds. (Since 1981 data represents only the first six months of 1981 compared to the entire calendar year of 1980, it is not possible to draw significant conclusions based on the difference between the 1980 and 1981 allocation of sources and uses of funds.) (See Table B-3.)

Furthermore, the study illustrated that, in 1980, 60 percent of the dollar volume and 65 percent of the number of all hospital tax-exempt bond financings did not result in an increase in bed complement, while for the first six months of 1981, 44 percent of the dollar volume and 43 percent of the number of hospital financings did not result in any bed increase.

TABLE B-1

HOSPITAL BOND ISSUES REPORTED AND SAMPLE UNIVERSE

	Calendar Year 1980		Six Months Ended June 30, 1981	
	No. of Issues	$ Volume (000's)	No. of Issues	$ Volume (000's)
PSA Universe (1)	294	2,020,405	148	3,438,283
BBI Universe (1)	338	3,558,760	172	2,560,000
Sample Universe (2)	194	3,458,241	113	2,550,375

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(1) These are tax-exempt bond issues for hospitals and medical care facilities in 1980 and the first half of 1981 as reported by the Public Securities Association and the Daily Bond Buyer. The PSA and BBI (Bond Buyer Index) universes are not necessarily the same. Some issues reported in one are not listed in the other.

(2) These 194 issues represent the universe of all issues over $5 million as reported by either the PSA or BBI.

TABLE B-2

SAMPLE SELECTED FOR STUDY

	Calendar Year 1980			
	Number of Issues	Percent	Dollar Volume (000's)	Percent
Sample Universe (1)	194	100%	$3,458,241	100%
Not Available (2)	29	14.9	274,661	7.9
Not Used in Study (3)	36	18.6	803,660	23.2
Study Sample	129	66.5	2,379,920	68.8

	Six Months Ended June 30, 1981			
	Number of Issues	Percent	Dollar Volume (000's)	Percent
Sample Universe (1)	113	100%	$2,550,375	100%
Not Available (2)	24	21.2	500,880	19.6
Not Used in Study (3)	17	15.0	408,770	16.0
Study Sample	72	63.7	1,640,725	64.3

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(1) These 194 issues represent the universe of all issues over $5 million as reported by the Public Securities Association or the Bond Buyer.

(2) There were 29 official statements for calendar year 1980 and 24 official statements for the first six months of 1981 that were not available at the time of the study.

(3) Certain issues over $5 million were excluded from the study because they represented GNMA, FHA, HEW, Hill-Burton Collateralized, or General Obligation Bond issues. In addition, certain issues were excluded because their use of proceeds included Life-Care Centers, Nursing Homes, For-Profit Institutions or Mental-Health Facilities.

TABLE B-3

SOURCES AND USES OF FUNDS

	1980		1981	
Sources of Funds:				
Hospital Equity Contribution	14.09%		8.30%	
Bond Proceeds	78.12		80.93	
Other[1]	7.79		10.77	
	100.00%		100.00%	
Uses of Funds:				
Equipment[2]	6.62%		4.28%	
Architect and Engineering Fees	4.50		3.04	
Construction Costs	54.02		52.22	
Total Project Costs		65.14%		59.54%
Refinancing		9.21		10.84
Issuance Costs[3]		1.19		1.38
Bond Discount		2.60		3.38
Debt Service Reserve Fund		8.98		9.88
Capitalized Interest Fund		12.78		13.87
Other Costs		0.10		1.11
		100.00%		100.00%

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[1] Comprised chiefly of interest earned on invested funds during the construction period.

[2] This is usually movable equipment. Most fixed equipment is included in the construction costs.

[3] Legal fees, printing, financial feasibility, etc.

APPENDIX C: Impact of Hospital Tax-Exempt Bonds on Interest Costs Reimbursed by Medicare/Medicaid System

Tax-exempt revenue bonds have allowed nonprofit hospitals to significantly lower their costs of borrowing funds for needed expansion and modernization projects. The yield on long-term tax-exempt bonds has traditionally been 35 to 40 percent lower than the yield on comparable taxable issues, such as corporate bonds. These lower interest costs have in turn been translated into savings for the Medicare and Medicaid programs in the form of lower interest cost reimbursements to hospitals.

To estimate the dollar amount of interest cost reimbursements saved by the Medicare and Medicaid programs due to tax-exempt provisions, it will be necessary to hypothesize about what the yield on hospital bonds would have been had the bonds not been tax-exempt.

Table 12 (text) shows the average net interest cost (NIC) for tax-exempt hospital issues from 1979 through the first half of 1981. Also shown are average yields on Aaa to Baa rated municipal bonds for those years. Note that the NIC for tax-exempt hospitals has been consistently higher than the yield on Baa municipal bonds.

Table 13 (text) shows average yields for corporate bonds rated Aaa to Baa. In 1979, the yields on municipals were 62 percent of the yield on corporates with a comparable rating. This figure rose to 65 percent in 1980 and to 70 percent in 1981. If we translate the NIC figures for tax-exempts using these factors, we obtain a reasonable estimate of the hypothetical NIC on taxable hospital issues. We can now use the hypothesized NIC differential to estimate the dollar amount of additional interest costs which would have been incurred if tax-exempt financing had not been available to hospitals.

Table 14 shows the additional interest cost reimbursement the Medicare and Medicaid programs would have incurred had there been no tax-exemption provisions in effect. For example, in 1979, almost $3.5 billion in hospital tax-exempts were issued at an average NIC of 7.71 percent, representing $270 million in interest payments the first year. Had the bonds been taxable, annual interest payments would have been $435 million, an additional cost of $165 million that year. If we assume an average life of 25 years for the bonds, the cumulative additional interest costs to maturity would have been approximately $3.5 billion. For bonds issued in 1980, this figure would have been $4.0 billion and for the bonds issued in the first half of 1981 the figure would have been $2.9 billion. This would have produced a total additional interest cost of $10.4 billion for bonds issued since 1979.

STATEMENT OF THE HEALTHCARE FINANCIAL MANAGEMENT ASSOCIATION

The Healthcare Financial Management Association (HFMA) is pleased to have an opportunity to testify on trends in municipal financing and the use of tax-exempt bonds. HFMA is a professional society representing more than 22,000 members who are directly or indirectly associated with financial management in hospitals and other healthcare organizations. These members are very concerned with assuring adequate capital for their organizations.

HFMA shares this committee's concerns about the massive deficits confronting our country. While some changes in use of tax-exempt financing may be called for in certain instances, discussion of tax-exempt bonds should not confuse the purpose of all such financings with such private objectives as owner-occupied housing. Small-issue industrial development bonds (IDBs) and mortgage subsidy bonds (MSBs) are, in virtually all cases, intended for private use. We believe hospital revenue bonds, along with bonds for sewers, transit systems, highways and schools serve important public purposes and, therefore, should remain tax-exempt. We believe that community resources that benefit a broad segment of the public should have access to tax-exempt financing, whereas projects that benefit only a narrow segment of the public—and are essentially private activities—need not be tax-exempt. It is important that tax-exempt hospital revenue bonds be viewed as financing a public purpose.

There is general agreement that hospitals serve an important public purpose. They provide genuine assistance to the ill and the injured without regard to race, sex, age or ability to pay. The nearly 6,000 community hospitals in the United States fall within three classes of ownership. First, more than 3,300 community hospitals are tax-exempt charitable organizations. These eleemosynary institutions account for 57 percent of all nonfederal hospitals and 70 percent of all hospital beds. Many of these charitable organizations were originally established, and continue to be operated, by religious organizations.

The second largest class of hospitals is the 1,800 state, county, and city owned community hospitals. These account for 31 percent of all nonfederal hospitals and 21 percent of all hospital beds in our nation. While some of these are huge public general hospitals, like Cook County Hospital in Chicago or the nearly two dozen hospitals operated by the New York City Health and Hospital Corporation, the vast majority of these government-owned hospitals have fewer than 100 beds and many are located in rural parts of America.

The third group of community hospitals in the United States is investor-owned institutions. These account for 12 percent of all nonfederal hospitals and only 9 percent of hospitals beds in our country.

Tax-exempt community hospitals began to employ tax-exempt revenue bonds in the early 1970s to finance their needs for expansion, renovation, replacement and modernization. The initial use of tax-exempt bonds by these institutions coincided with an enormous surge in demand for hospital services brought about by the enactment of the Medicare and Medicaid programs. Also Hill-Burton grant and loan funds (authorized by the Hospital Survey and Construction Act of 1946) which had been an important source of capital, no longer provide significant funding. Furthermore, private philanthropy and funds generated through internal operations have not kept pace with hospitals' capital requirements. Therefore, community hospitals have had to increasingly rely on debt financing. The most frequently used source of debt financing available today to tax-exempt community hospitals and to government-owned community hospitals is tax-exempt bonds issued by state and local bonding authorities. Very few of these bonds are general obligation instruments; most are revenue bonds. Investor-owned community hospitals rarely use tax-exempt financing for their projects, and when tax-exempt financing is used on occasion by an investor-owned hospital, it generally involves a small rural institution that is the sole community provider.

Hospitals are often criticized for over-building. The truth is that very few hospital beds have been added in recent years, and these were added to meet increasing demands for hospital services due to population growth, migration and aging. In fact, hospitals are subject to very stringent certificate-of-need requirements that were established in the National Health Planning and Resources Development Act of 1973 and subsequent amendments to this act. During the last decade, no tax-exempt bond has ever been issued for hospitals that had not first obtained approval from their State Health Planning and Development Agency.

The vast majority of hospital revenue bonds are issued to meet essential renovation and replacement needs. About half of the community hospitals in existence today are over a quarter of a century old. In many of our nation's older cities, there are hospitals in operation today that were originally built more than 50 years ago. Due to population shifts, not all of these obsolete facilities need to be replaced, but many do. In addition, due to significant advances in equipment-embodied medical technologies, hospitals today face major capital requirements for modernization in order to avoid rapid technological obsolescence. Tax-exempt bond financing is essential to meeting these important capital requirements and to keeping America's hospitals strong and healthy.

If action is taken to curtail the use of tax-exempt private purpose bonds, we urge that nothing limit tax-exempt bond financing for America's community hospitals. Already there are many signs of a looming capital shortfall for community hospitals in this decade. We are deeply concerned about an increasing number of reports suggesting that hospitals will not be able to obtain sufficient capital during the coming decade to maintain their current level of excellence.

In closing, we want you to know that we have carefully monitored tax-exempt hospital revenue bond financing during the past three years, and we have published several dozen major articles on this topic in our monthly publication, the Healthcare Financial Management Journal. One of these that appeared in April 1982, by George C. Phillips Jr. entitled, "Tax-exempt Hospital Bonds: Key Questions and Answers" was submitted as part of Mr. Phillips testimony. Attached to our testimony is an article from our July 1982 Journal written by Anthony Taddy and Gordon Gayer. It presents the results of a major study conducted by the Health Care Financing Study Group. Next week we will be publishing a new book on capital financing of healthcare facilities.

We urge that the essential public purpose of tax-exempt bonds for use by hospitals and other healthcare facilities by recognized in future discussion of tax-exempt bonds. Thank you for this opportunity to present our views. We would be pleased to answer any questions that may be directed to Ronald R. Kovener, Vice President or Walter J. Unger, Associate Director of Professional Affairs at 296-2920.

RESULTS OF STUDY—USES AND EFFECTS OF HOSPITAL TAX-EXEMPT FINANCING

(By Anthony J. Taddey and Gordon Gayer)

Editor's note.—The Health Care Financing Study Group is an informal association whose member firms participate in hospital capital financing transactions. Its members include hospital investment banking and underwriting firms, law firms with bond counsel expertise, accounting firms and hospital consulting firms. To investigate hospital tax-exempt financing and its related policy questions, a special committee of member firms was formed.

These firms made substantial commitments of time and expertise to the process of conducting the research and generating the results which are reflected in the HCFSG's May 1982, study, "The Uses and Impacts of Hospital Tax-Exempt Financing." This article is based on that study.

HCFSG Chairman Anthony J. Taddey, manager of the Health Care Finance Department at Merrill Lynch White Weld Capital Markets Group, headed the effort. Counsel Gordon Gayer of O'Connor and Hannan, Washington, D.C., coordinated the project.

The HCFSG member firms which contributed to the study are: Amherst Associates; Blyth Eastman Paine Webber Health Care Funding; Butcher & Singer; Goldman, Sachs & Co.; Lehman Brothers Kuhn Loeb, Inc.; Merrill Lynch White Weld Capital Markets Group; John Nuveen & Company, Inc.; Smith Barney, Harris Upham & Co., Inc.; Squire, Snaders, & Dempsey; Underwood, Neuhaus & Company.

During the last decade, the use of tax-exempt financing by America's hospitals has grown dramatically—from $.26 billion in 1971 to $5.04 billion in 1981. The growth has taken place during a period of increasing concern over healthcare costs. Thus it comes as no surprise that healthcare policy makers have begun to question the role tax-exempt hospital bonds play in the healthcare cost equation.

These questions have often been raised as part of two broader policy issues: the overall effect of tax subsidies for medical care, and the appropriateness of tax-exempt financing in general.

Despite the growing debate, some of the most policy-relevant questions about hospital tax-exempt financing have received little study. This article, reporting on a study of the uses and effects of hospital tax-exempt bonds, attempts to answer some of these questions.

Four broad areas are addressed. First, the actual growth in the use of hospital tax-exempt financing over the last decade was measured. In this assessment, government figures, as well as independent estimates developed by the financing industry, were used. The volume of hospital bonds was examined in the context of the entire municipal bond market. Growth in the use of hospital bonds and reasons for that growth were analyzed. What happened to other sources of hospital capital during the last decade was also researched.

Second, the uses to which hospitals put the funds they derive from the sale of tax-exempt bonds was analyzed. How much was spent on construction, and how much was used for other purposes, such as renovation and refinancing were investigated. What has happened to the volume of hospital construction during the period in which the use of tax-exempt hospital financing grew so rapidly was also studied.

Third, in what is perhaps the heart of the study, the various effects of the use of tax-exempt hospital financing were examined. What would happen to hospital charges, and to hospitals' financial position, if tax-exempt bonds were not available? Have tax-exempt hospital bonds had an effect on overall interest rates? Have hospital bonds caused a boom in hospital construction?

The effects the bonds have on the Federal budget and the Federal Treasury are also examined. How much does tax-exempt hospital financing cost the government in lost tax revenue? How much do the bonds save hospitals in interest costs, and how much do they then save the government through decreased Medicare/Medicaid reimbursement for these costs?

What "reflow effects" exist? That is, how much does the government receive in taxes on construction, jobs and other economic activity generated by the use of tax-exempt hospital bonds? On the bottom line, how much do the bonds cost the Federal government, if anything?

Fourth, the future of tax-exempt hospital financing was considered. While one view of the future necessarily contains elements of speculation, informed speculation seems imperative since the hospital industry faces wholesale restructuring and an unprecedented need for capital during the next decade. What will happen to the volume of tax-exempt hospital bonds in the future? Will it continue to grow, or has it peaked? What would happen to the healthcare industry if hospital bonds were eliminated

To answer these questions, the existing literature on the subject of hospital bonds was surveyed and original research was conducted. A summary and an explanation of the findings follow.

The use of tax-exempt hospital bonds, which grew rapidly during the early and mid-1970's, has settled into a pattern of slow growth in recent years.

During the early and mid-1970's, the use of tax-exempt bonds to finance hospital capital projects jumped, as Table 1 and Exhibit 1 show. This rapid increase occurred primarily for two reasons. First, as Table 2 shows, other sources of capital funding, such as government grants and philanthrophy, shrank markedly. Second, the legal mechanisms required to sell the bonds, such as public bond authorities, were not set up in many areas until the 1970's.

Since the middle 1970's, the growth rate for bond use has slowed. As Exhibit 1 graphically illustrates, bond use has actually flattened, when measured in constant dollars. With the single exception of 1977, all the years from 1976 to 1981 experienced an annual volume of between $1.4 billion and $1.9 billion in 1967 dollars.

Tax-exempt bonds play an important role in helping hospitals hold down costs.

If hospitals had been unable to use tax-exempt financing, their costs and charges would have increased by an average of 7 percent over current levels, unless they allowed their financial positions to deteriorate. This increase would contribute to inflation and would have an adverse effect on the Federal budget, through inflation-indexed transfer payments and Federal health spending. To quantify this effect, the financial characteristic of the prototypical hospital using tax-exempt financing were created from data contained in 1980 tax-exempt hospital bond official statements. The data base included 102 issues [1] out of a total of 294 issued in 1980. These issues accounted for 61 percent of total dollar volume of the tax-exempt hospital revenue bonds brought to market that year. Data regarding these hospitals were grouped into four bond rating classes:

AA+, AA (6 issues);
A+, A (57 issues);
A− (22 issues);
BBB+ and lower (17 issues).

Financial data for a composite hospital in each rating class were developed by combining the data for all hospitals in the sample from that rating class.

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[1] Only tax-exempt revenue bonds for at least $5 million, which were rated by Standard and Poor's or Moody's, and whose official statements contained feasibility studies, were included. Insured bonds were excluded.

It was assumed that if tax-exempt financing were unavailable, hospitals would use taxable bonds to finance capital expenditures. Interest rates for taxable bonds were assumed to be 2 or 5 percentage points higher than tax-exempt rates. Maturities were assumed to be 15 or 25 years, based on the range of observed financing terms for taxable bonds. Four taxable bond scenarios were developed using the different combinations of these financing terms.

Taking debt service coverage [2] as a key measure of financial position for the composite hospital in each rating class, the charge increases necessary to maintain the same debt service coverage for each taxable bond scenario were calculated. Additionally, debt service coverage for a midpoint scenario for each of the classes was calculated, assuming a 3.5 percent interest rate spread with a 20-year maturity. The results are shown in Exhibit 2.

TABLE 1.—TAX-EXEMPT HOSPITAL BONDS ISSUED, 1971–1981, IN CURRENT AND CONSTANT DOLLARS [IN MILLIONS] [1]

	Current dollars	Constant (1967) dollars
1971	262.0	216.0
1972	525.0	419.0
1973	610.6	458.3
1974	1,282.4	868.2
1975	1,959.0	1,215.3
1976	2,725.6	1,598.6
1977	4,731.5	2,606.9
1978	3,121.8	1,597.6
1979	3,153.5	1,450.6
1980	3,624.0	1,468.4
1981	5,040.0	1,850.2

[1] For 1971–79, Congressional Budget Office, "Tax Subsidies for Medical Care: Current Policies and Possible Alternatives," Washington: Government Printing Office, 1980 (hereinafter CBO Report), Table 7, 49; for 1980, Public Securities Association; for 1981, Weekly Bond Buyer (figures adjusted for growth in Consumer Price Index).

TABLE 2.—SOURCES OF FUNDING FOR HOSPITAL CONSTRUCTION [1]

	1973 (pct.)	1978 (pct.)
Government grants and appropriations	23.5	8.6
Philanthropy	10.4	6.2
Taxable bonds	4.8	2.8
Direct loans	17.0	8.0
Internal funds	16.4	18.5
Tax-exempt bonds	20.9	49.3

[1] American Hospital Association, "Report on Tax-Exempt Hospital Financing," unpublished paper, 1980, p. 5; See also Lightle, Mary Alice, "Changes in the sources of capital" Hospital Financial Management (February 1981), pages 42–47.

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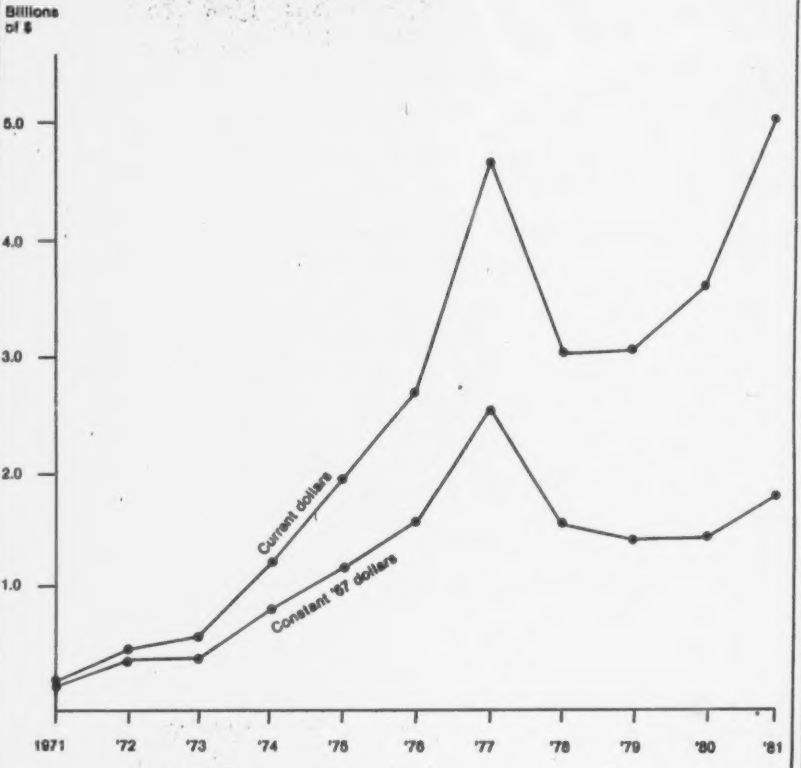
[2] Debt service coverage was calculated from the financial forecasts for the first fiscal year after project completion. Project completion was determined from the financial feasibility studies included in the official statement for each bond issue.

Exhibit 1: Tax-exempt hospital revenue bonds issued[1]
1971–1981



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[1] The data for this chart are taken from Table 1.

The percentage increases in patient charges required to maintain the same debt service coverage for the taxable as for the tax-exempt financing alternatives ranged from 1.8 percent for the highest bond rating class under the most favorable financing scenario to 16 percent for the representative hospital in the A-rating class under the least favorable terms.

EXHIBIT 2.—SUMMARY OF PERCENTAGE INCREASES IN HOSPITAL CHARGES ATTRIBUTABLE TO TAXABLE FINANCING ALTERNATIVES BY RATING CLASS, ASSUMING DIFFERENT FINANCING TERMS AND CONSTANT DEBT SERVICE COVERAGE RATIOS

[Interest rate differentials and maturities for taxable bonds]

	Pct.	Pct.	Pct.	Pct.	Pct.
Rating	+2	+5	+2	+5	+3.5
Class (yrs.)	25	25	15	15	20
AA+, AA	1.8	4.0	4.5	6.3	3.6
A+, A	5.3	7.2	8.1	11.3	6.6
A−	4.5	9.9	11.7	16.0	9.2
BBB+ and lower	3.8	8.3	10.1	13.7	7.8
All rating classes	3.5	7.6	8.8	12.1	7.0

EXHIBIT 3.—SUMMARY COMPARISON OF HOSPITAL DEBT SERVICE COVERAGES UNDER TAX-EXEMPT AND TAXABLE FINANCING ALTERNATIVES BY RATING CLASS, UNDER VARYING FINANCING TERMS

Rating class	1980 tax-exempt financing terms	Interest rate differentials and maturities for taxable bonds			
		+2% 25 yrs.	+5% 25 yrs.	+2% 15 yrs.	+5% 15 yrs.
AA+, AA	3.10x	2.89x	2.67x	2.60x	2.47x
A+, A	2.40x	2.14x	1.91x	1.85x	1.71x
A−	2.00x	1.79x	1.59x	1.51x	1.41x
BBB+	1.66x	1.51x	1.37x	1.30x	1.22x

EXHIBIT 4.—DISTRIBUTION OF RATINGS OF HOSPITAL TAX-EXEMPT REVENUE BONDS [1]

Rating	Percentage
AA or better	3
A+, A	62
A−	15
BBB+ or below	20
	100

[1] Condon, William P., "Hospital revenue bonds—how they're rated," Hospital Financial Management (September 1981), p. 60–70.

In general, those hospitals whose financial positions are the weakest, in the estimation of professional bond raters, will have to increase their charges the most to maintain their present debt service coverage ratio and financial position. Combining all hospitals in the sample across all rating classes, one finds required charge increases ranging between 3.5 percent and 12.1 percent, depending upon the interest rate differential and available maturity assumed for the taxable bond alternatives.

The overall weighted average increase in charges for the "mid-point" scenario (3.5 percent rate differential and 20-year maturity) would have been 7.0 percent. Thus, to achieve the same debt service coverage under the greater financial burden of taxable financing, the average hospital would have been forced to increase its patient charges by 7 percent if tax-exempt bonds were not available.

Tax-exempt bonds have been instrumental in helping hospitals maintain their financial position.

Without the use of tax-exempt bonds, the financial position of many of the nation's hospitals would deteriorate unless charges were increased significantly. If taxable bonds were used instead of tax-exempt bonds to finance hospital capital projects, debt service coverage ratios would drop for most hospitals, resulting in a bond rating drop of one rating class. Taxable bond use would also lead to higher debt-to-equity ratios, less available working capital, and potential erosion of hospital endowments—all leading to a weaker financial position for hospitals.

The financial position of the hospital industry as measured by debt service coverage, would be adversely affected by the elimination of tax-exempt financing. Using the composite hospitals described, the revised debt service coverage ratios were calculated for each taxable financing scenario, assuming that cost-based payors (Medicare, Medicaid) reimburse their proportionate share of the higher interest expense associated with taxable financing, but that hospitals' charge structures are not changed. (See Exhibit 3.)

For all taxable financing scenarios except the one with the most favorable terms (2 percent rate differential; 25-year maturity), the debt service coverage ratio drops to such an extent that the rating for the hospitals concerned would be expected to fall by one rating class. Such a drop would adversely affect the interest rates which would have to be paid for taxable financing, increasing the interest rate differential and further exacerbating the effects on financial position.

Additionally, the rating drop would seriously jeopardize the marketability of bonds issued by hospitals in at least the lower two rating classes. More than one-third of all hospitals might therefore be denied access to capital markets, based on the data in Exhibit 4.

In addition, since the debt service coverages for bonds in each of the rating classes fall into a range, of which only the average is shown in Exhibit 3, the financial position of a significant portion of the hospitals involved would be expected to be worse than the averages shown, without large charge increases.

A second approach to assessing the effect of the elimination of tax-exempt bonds on the financial position of hospitals is to examine the effects of the substitution of taxable for tax-exempt financing on hospital reserves and equity, again assuming no additional charge increases. Using the representative A+/A rated hospital previously described, the effects were computed for the alternative debt service schedules associated with taxable financing on annual cash flows and investment income. As can be seen in Exhibit 5, the cumulative adverse effect on cash for the representative A+/A rated hospital ranged from $56.5 million to $318.4 million over the term of the borrowing, depending on the financing terms of the taxable bonds.

EXHIBIT 5.—AN ANALYSIS COMPARING THE INCREMENTAL CASH OUT-FLOW RESULTING WHEN A TAXABLE A+/A RATED BOND, UNDER VARYING FINANCING TERMS, IS SUBSTITUTED FOR A $20,000,000 A+/A RATED TAX-EXEMPT BOND [1]

[Dollars in millions]

A+-A rated bonds	Interest rate differentials and maturities for taxable bonds			
	Tax-exempt +2 pct. 25 yrs.	Tax-exempt +5 pct. 25 yrs.	Tax-exempt +2 pct. 15 yrs.	Tax-exempt +5 pct. 15 yrs.
Cumulative net cash outflow at maturity	$56.5	$216.0	$109.4	$318.4
Net present value in 1980 dollars of cumulative net cash outlflow [2]	$2.0	$3.6	$3.9	$5.3
Percentage reduction in equity	7.8	13.8	15.0	20.3

[1] Note: The dollar amounts in Exhibit 5 are predicated on a bond issue of $20,007,000.

[2] Not present value based on discount rate equal to assumed taxable borrowing rate for each scenario.

EXHIBIT 6: USES OF HOSPITAL CAPITAL

Projects costs	1980		1981	
Equipment[1] (pct)	6.62		4.28	
Architecture and engineering fees	4.50		3.04	
Construction costs	54.02		52.22	
Total (pct)		65.14		59.54
Refinancing		9.21		10.84
Issuance costs [2]		1.19		1.38

EXHIBIT 6: USES OF HOSPITAL CAPITAL—Continued

Projects costs	1980	1981
Bond discount	2.60	3.38
Debt service reserve fund	8.98	9.88
Capitalized interest fund	12.78	13.87
Other costs	.10	1.11
Total (pct)	100.00	100.00

[1] This is usually movable equipment. Most fixed equipment is included in the construction cost.

[2] Legal fees, printing, financial feasibility, etc.

In present-value 1980 dollars, the adverse effect ranged from $2.0 million to $5.3 million per hospital, representing between 7.8 percent and 20.3 percent of the total equity for the representative hospital.

While construction is the most important use of tax-exempt capital by hospitals, other uses are also important.

In order to examine how hospitals use capital raised from the sale of tax-exempt bonds, a random sample of official statements for bond sales of $5 million and more was analyzed. The universe of issues excluded those which were used to finance nursing homes, for-profit hospitals, or mental health facilities, or which represented Federally guaranteed or state general obligation bonds. The sample consisted of 30 bond issues for 1980, and 15 for the first half of 1981.

Exhibit 6 shows that "project costs" (construction, equipment, and architectural and engineering fees) consumed between 60 percent and 65 percent of the funds raised by hospitals through tax-exempt bonds during recent years. Refinancing of prior debt and the investor-required debt service reserve each accounted for approximately 10 percent of the funds. Capitalized construction-period interest accounted for an additional 13 percent of the funds.

The growth of hospital tax-exempt financing has not led to a boom in hospital construction and the addition of new beds.[1]

Exhibit 7 shows that while the volume of tax-exempt hospital bonds issued increased nearly 580 percent in constant dollars between 1971 and 1980, the volume of hospital construction fell by 34 percent in constant dollar terms during the same period. The supply of hospital beds, moreover, is growing very slowly—and primarily in areas of population growth.

Tax-exempt hospital bonds cost the Federal government very little, if anything; they may even be net revenue producers for the Treasury.

Tax-exempt hospital financing has been accussed of creating a drain on the Federal Treasury and thus adding to the chronic imbalance of the Federal budget.[2] This charge was found unsupportable for three main reasons.

Estimates of Federal tax revenue losses caused by hospital tax-exempt bonds are unrealistic and inflated.

The bonds have actually saved the Treasury significant amounts by reducing hospitals' interest expenses, thus cutting Medicare and Medicaid reimbursement for these costs.

The bonds stimulate the creation of jobs and additional Federal tax revenues. The use of taxable bonds would reduce this stimulus somewhat, since the higher taxable interest rates would force hospitals to issue a smaller volume of bonds.

First, the Congressional Budget Office (CBO) is the principal source for estimates of the tax revenue losses caused by tax-exempt hospital bonds. The CBO has contended that the bonds cost the Treasury $400 million in foregone tax revenues during fiscal year 1980.[3] This estimate is based on an assumption about the bond market that has been roundly criticized.

The CBO assumed that tax-exempt financing displaces primarily taxable financing from other sources rather than consumption, saving or other tax-exempt financing. The CBO contended that when tax-exempt financing is introduced into the market, it causes a "chain reaction" among investors: each investor moves down a rung on the ladder of securities ranging from fully taxed to tax-exempt.

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[1] See also, Valiante, John D., "Policy issues in heathcare capital management," Hospital Financial Management (January 1981).

[2] CBO Report, p. 47–48.

[3] CBO Report, p. 47.

EXHIBIT 7.—TAX-EXEMPT HOSPITAL BONDS ISSUED VS. HOSPITAL CONSTRUCTION COMPLETED: 1971–1980, IN CONSTANT (1967) DOLLARS [MILLIONS][1]

	Tax-exempt hospital bonds issued	Hospital construction completed
1971	$216	$2,872
1980	$1,468	$1,883
Change 1971–1979 (pct)	Up 580	Down 34

[1] (a) For tax-exempt hospital bonds issued: CBO Report, table 7, p. 49 (figures adjusted for growth in Consumer Price Index); and (b) for hospital construction completed: Bureau of the Census figures.

EXHIBIT 8.—ADDITIONAL INTEREST COSTS OF TAXABLE VS. TAX-EXEMPT HOSPITAL BONDS

Year	Hospital tax-exempts issued [1]	1979 to 1981 (in millions) tax-exempt interest payments	Interest payments if taxable	Additional interest cost
1979	$3,154	$243	$392	$149
1980	3,624	351	540	189
1981 [2]	2,562	299	428	128

[1] For 1979, CBO Report; for 1980, Public Securities Association; for 1981, Daily Bond Buyer.
[2] 6-month data.

This "chain reaction" scenario has been widely disputed. The CBO errs in assuming that investors select their portfolios of assets based entirely upon consideration of the tax treatment of those assets.[1] Such an assumption is inconsistent with the facts of actual asset holdings in the economy and with widely accepted and empirically verified portfolio theory. Investors also consider possible risks and returns associated with their investments. CBO's unrealistic view of investor behavior causes it to overestimate tax revenue losses by a factor of six or seven.[2]

Thus, the direct tax revenue loss caused by tax-exempt hospital bonds may be $60 million to $70 million in fiscal year 1980—not $400 million.

REDUCED REIMBURSEMENT

Second, hospital tax-exempt bonds provide substantial savings to the Medicare and Medicaid programs through reduced reimbursement for hospitals' interest expenses. By using tax-exempt rather than taxable bonds, hospitals are able to reduce the interest rate they must pay on their debt. This cuts interest expenses significantly.[3]

These interest expense reimbursement savings can be seen by looking at new issues during the last several years. The percentage point spread between the interest rate on taxable corporate bonds and on tax-exempt municipal securities, in comparable rating categories, was investigated. The average net interest cost for hospital bonds would have been approximately 5 percentage points higher during 1979, 1980 and the first half of 1981 if the bonds had been taxable rather than tax-exempt. As Exhibit 8 shows, these higher interest rates would have raised hospitals' interest costs on new bond issues by $149 million in 1979, $189 million in 1980, and $128 million in the first half of 1981.

Medicare and Medicaid reimburse hospitals for approximately 35 percent to 40 percent of all expenses, including interest costs.[1] To make a conservative estimate, the Federal government, through Medicare and Medicaid, saved approximately one-third of hospitals' total interest savings on new issues during these years—roughly $50 million in 1979, $63 million in 1980, and $42 million in the first half of 1981. Thus, the use of tax-exempt bonds by the nation's hospitals saved the Treasury a total of $155 million in reduced Medicare and Medicaid reimbursement for interest exenses in just the first year's interest payments on new bonds issued in 1979, 1980 and the first six months of 1981.

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[1] Kormendi, Roger C. and Thomas T. Nagle, "A Critique of the CBO Estimates on the Federal Revenue Losses from Industrial Development Bonds," unpublished paper, 1981, pp. 2–6.

[2] For a discussion of, inter alia, the effect that investor behavior and expectations may have on tax-exempt hospital bond rates during 1982, see Mansdorf, Bruce D., Joseph R. Marion, and Alex Rorke, "Bond market forecasting: What can hospitals expect in 1982 financial market?" Hospital Financial Management, January 1982, pp. 34–43.

[3] See, also, Phillips, George C. Jr., "Tax-exempt hospital bonds: Key questions and answers," Hospital Financial Management (April 1982), p. 42.

[1] Gibson, Robert M. and Daniel R. Waldo, "National Health Expenditures, 1980," in Health Care Financing Review, September 1981, Table 7A, p. 48.

REDUCED INTEREST PAYMENTS

The savings the Treasury derives from reduced interest payments on all outstanding hospital bonds during a single year—1980—was examined. The CBO estimated that by 1980, $15.4 billion in tax-exempt hospital bonds were outstanding.[2] Although interest rates have varied during the years these bonds were issued, these rates would have been higher if they had not been tax-exempt. A conservative estimate would be that taxable interest rates have averaged at least 3 percentage points more than tax-exempt rates. Thus, hospitals saved at least 3 percent of the $15.4 billion in outstanding bonds in interest expenses during 1980 alone—approximately $460 million. The Federal government's share of these savings (through reduced Medicare and Medicaid interest expense reimbursement) is at least one-third of the total, or more than $150 million.

Another way to illustrate the Federal government's participation in the cost-savings through lower tax-exempt interest rates is to see how much the Treasury saves over the life of the bonds issued in 1980. Assume an average life of the bonds of approximately 25 years.[3] If the tax-exempt hospital bonds issued in 1980 had been issued taxably, the cumulative additional interest costs to maturity would be approximately $4 billion.[4] Under the present Medicare and Medicaid reimbursement system, the Federal government would reimburse hospitals at least one-third of this amount—more than $1.3 billion.

Third, tax-exempt hospital bonds have "reflow effects" that benefit the Federal treasury. Tax-exempt hospital bonds allow hospitals to grow and expand. They stimulate the creation of new jobs, lead to increased sales of supplies and equipment, and generate increased economic activity in other ways as well.

This, in turn, results in additional tax revenues for local, state, and Federal governments. If the use of tax-exempt hospital bonds were proscribed, and hospitals were forced to rely on taxable bonds, the amount of hospital capital spending, and thus construction, would fall. This decline in construction would, in turn, reduce the reflow effects which enrich the Federal Treasury.

The precise amount of the additional tax revenue generated by a given amount of tax-exempt hospital financing is difficult to measure. However, it is significant that researchers have found that small-issue tax-exempt IDBs generate net gains in tax revenues for Federal, state, and local governments as the restrictions on their volume are relaxed.[5] While it is beyond the scope of this study to estimate similar reflow effects for hospital tax-exempt bonds, they clearly exist, and must be considered in any calculation of how tax-exempt hospital bonds affect the Treasury.

In summary, while the effect of tax-exempt hospital bonds upon the Federal Treasury is difficult to estimate with precision, the evidence supports a figure far lower than that given by the CBO. The CBO's estimate of $400 million in fiscal 1980 for direct tax revenue losses caused by the bonds is highly exaggerated. A figure of $60 million to $70 million appears to be much closer to the mark.

More than offsetting these tax revenue losses are the significant savings in Medicare and Medicaid interest expense reimbursement realized as a result of the use of tax-exempt hospital bonds. These savings are at least $150 million during fiscal 1980.

Finally, any assessment of the fiscal effect of these bonds must include consideration of increased tax revenues that result from the capital investments made by hospitals using tax-exempt bonds. In short, the contention that hospital tax-exempt bonds cost the Treasury money has not been adequately proven. To the contrary, the bonds may save the Treasury money over the long run.

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[2] CBO Report p. 47.

[3] The estimate is, if anything, conservative. The average life of hospital tax-exempt bonds issued today is closer to 30 years.

[4] In 1980, almost $3.6 billion in tax-exempt hospital bonds were issued at an average net interest cost of 9.69 percent, representing $341 million in interest payments the first year. Had the bonds been taxable, annual interest payments would have been $525 million, an additional cost of $184 million that year. Over the average bond life of 25 years, the cumulative additional interest costs to maturity would be $4.0 billion.

[5] Norman B. Ture, "Economic and Federal Revenue Effects of Changes in the Small-Issue IDB Provision," unpublished paper, 1980, p. 11-12.

Tax-exempt bonds are needed to play a vital role in the future capital financing plans of the nation's hospitals.

The 1980's shape up as a decade during which the hospital sector will exert an unprecedented demand for capital. The hospital financial community is nearly unanimous in pointing to capital formation as the crucial issue for hospital survival during the next 10 years.[1] Capital will be needed in large amounts for the maintenance of facilities, and for the renovation and replacement of worn-out physical plants.

Large infusions of capital will also be needed to accomplish an essential organizational transformation of the industry. In one of its dimensions, this transformation will be a consolidation into more efficient units. In another, equally important dimension, it will take the form of new patterns in the delivery of care, as exemplified by increasing resort to ambulatory care in outlying facilities. Both institutional consoldiation and construction of new ambulatory care facilities will require capital.

In addition, as in any other industry undergoing structural change, the individual hospital will require access to sufficient working capital to absorb the shock of adjusting to the industry new structure.

The growing need for hospital capital has been documented by several sources. For example, one hospital investment banking group has projected a need for no less than $190 billion in capital between now and 1990, merely to maintain the existing hospital plant.[2] Even if the industry's bed count were reduced 15 percent (a rather unattainable goal), there would still be a need for $158 billion in capital spending.[3]

The Federal government itself agrees with this perception of a major new need for hospital capital. HHS officials have made a conservative estimate that the demand for hospital capital will reach $120 billion to $158 billion.[4] These figures are double and perhaps triple the levels of hospital investment required during the 1970's.[5]

In light of the hospital industry's very real and growing demand for capital, tax-exempt financing should be preserved as the cheapest, and for many hospitals the only, means of access to the private capital market.

STATEMENT OF HOLLIS R. DEAN, EXECUTIVE VICE PRESIDENT (FINANCE), HOUSTON LIGHTING & POWER CO.

Houston Lighting & Power Company (HL&P) is an investor-owned electric utility serving nearly one-fourth of the population of the State of Texas. During the past decade, HL&P has been faced with an exponential growth in demand for electricity in Texas and presently anticipates substantial growth to continue through the end of this century. HL&P is attempting to meet that increasing demand in large part with new coal- and lignite-fired plants.

Under the mandate of the Federal government, these new plants must be equipped with costly pollution control facilities. Nearly one-third of the cost of a new coal- or lignite-fired plant is attributable to pollution control equipment. Yet, the pollution control equipment does not itself increase generating capacity or reduce the cost of generating electricity. Rather, it represents a significant additional capital expenditure, which is mandated by Federal law to promote clearly defined Federal policy. In this regard, the cleaner air and water resulting from the use of such equipment benefits everyone, not just electric utility customers, in the service area.

As introduced, H.R. 1635 attempts, among other things, to place additional restrictions on the use of "private purpose" tax-exempt bonds in order to limit their dollar volume growth. In doing so, the bill would require the amount of recovery deductions for all property (other than certain residential rental property) to be computed by using the straight-line method (with a half-year convention and without regard to salvage value) and an extended recovery period. In the case of 15-year public utility property, the minimum required recovery period would be 22 years. The recovery period would be similarly extended to 5 years for 3-year property, 8 years for 5-year property, and 15 years for 10-year property.

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[1] See, e.g., Frank, Frederick and Michael Patrick George, "Capital management: Funding strategy among multi-hospital systems," Hospital Financial Management, September 1981, pp. 24-32.

[2] Hernandez, Michael D., "The Capital Structure of the Hospital Industry in the 80's," Kidder, Peabody & Co., Inc., June 1981.

[3] Id.

[4] "Briefing on Capital Issues," Bureau of Health Facilities, Department of Health and Human Services, Jan. 14, 1981.

[5] Id.

HL&P has significant problems with the provisions of H.R. 1635 relating to an extended recovery period. First and most important, the bill fails to distinguish between activities that serve a public or quasi-public purpose and activities that are inherently private. Some activities, such as the provision of solid waste treatment facilities, local electric distribution systems, and certain air or water pollution control facilities, serve primarily (if not exclusively) a public purpose. Other activities, viz., the building of industrial parks and the acquisition, construction, etc., of real property for small businesses, provide primarily (if not exclusively) a private benefit. Yet, the proposed restrictions would apply equally to all types of tax-exempt IDBs regardless of the public purpose of the financed activity.

The provision of pollution control facilities in connection with coal- or lignite-fired electric utility plants, in particular, serves a useful and clearly delineated public purpose. Again, the facilities are mandated by Federal law to provide cleaner air and water for all the people of the community served by the plant. Indeed, it cannot be said that a private purpose is even partially being served. The pollution control equipment does not create additional generating capacity and, by regulations, may not be profitable to operate. It creates only an additional cost of doing business, which is borne by the entire community served by the plant in order to promote a clearly delineated public policy. Moreover, the additional generating capacity of the plant itself provides the community as a whole with electricity and is an important part of the infrastructure of the local and national economy. Thus, the H.R. 1635's treatment of the provision of such pollution control facilities as a private purpose activity is misguided.

The second problem with H.R. 1635 concerns its economic effect on pollution control financing. As presently drafted, H.R. 1635 makes tax-exempt financing prohibitively expensive for 15-year public utility property and other recovery property. Under the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), much of the economic benefit provided by the tax-exempt financing of pollution control facilities was vitiated by requiring recovery deductions to be computed by using the straight-line method. If H.R. 1635 is enacted as presently drafted, however, such tax-exempt financing will become largely uneconomical. Thus, H.R. 1635 would effectively preclude the use of tax-exempt IDBs to finance most pollution control facilities used by coal- or lignite-fired elecric utility plants. HL&P thinks the elimination of such an important financing tool for pollution control facilities as tax-exempt IDBs would be most unwise and contrary to the public policy mandated by Federal law to promote cleaner air and water.

If enacted, the provision of H.R. 1635 relating to extended recovery periods would thus go far beyond merely slowing the growth in the dollar volume placements of IDBs, effectively stopping the use of tax-exempt financing by most taxpayers. The growth rate for new tax-exempt issues can be reduced just as effectively, however, simply by recognizing and addressing the source of that growth, viz., the small issue IDBs. According to estimates made last year by the Treasury Department, between 1976 and 1981 the annual rate of growth for small issue IDBs has been 50 percent. This growth is much greater than the relatively moderate annual growth rate during that period for other IDB issues. For example, the annual rate of growth between 1976 and 1981 for pollution control IDBs and for private hospital IDBs has been 13 percent each, and housing IDBs have grown at an annual rate of 18 percent. Moreover, the Treasury estimates that of the total $25 billion of IDBs marketed in 1981, $10.5 billion of them were small issue IDBs. Thus, the source of the growth problem is almost entirely attributable to the small issue IDBs.

To the extent that the restrictions of IDB financing recently enacted by TEFRA do not sufficiently slow the annual growth rate for small issue IDBs used to finance purely private activities, perhaps additional restrictions should be placed on such financing. But in doing so, Congress should not also effectively eliminate the use of IDB financing for truly public and quasi-public activities such as the provision of pollution control facilities. Regardless of whether the user of those facilities is a small or large business or a governmental agency, the facilities truly serve a public purpose, viz., the provision of cleaner air or water. This Congress would be making a tragic mistake by effectively eliminating one of the most useful financing tools available for the provision of pollution control facilities. Indeed, it is ironic that Congress would seriously consider placing additional restrictions on the financing of those very facilities that Congress has mandated must be installed.

Finally, HL&P understands that an unintended interpretation of H.R. 1635 as presently drafted would apply its restrictions to property that is currently excepted from the restrictions generally imposed under present law by virtue of the transitional rule of TEFRA § 216(b)(2). TEFRA § 216(b)(2) provides, among other things, that the restrictive provisions of Code section 168(f)(12) enacted by TEFRA (requiring the use of the straight-line method of cost recovery for facilities financed by tax-exempt bonds) will not apply to certain facilities with respect to which construction commenced, or a binding agreement to incur significant expenditures was entered into, before July 1, 1982. A repeal of the transitional rule provided by TEFRA § 216(b)(2) would be extremely unfair and would substantially penalize taxpayers, such as HL&P, that have commenced construction or have made substantial financial commitments to acquire, pollution control facilities based on the understanding that full ACRS deductions would be allowed. Accordingly, to avoid any such unintended and unfair interpretation of H.R. 1635, HL&P suggests that clarifying language be added clearly indicating that H.R. 1635 does not repeal the transitional rule of TEFRA § 216(b)(2).

STATEMENT OF THE BOARD OF DIRECTORS, ILLINOIS FARM DEVELOPMENT AUTHORITY

Representatives: The Illinois Farm Development Authority (IFDA) is an Authority of the State of Illinois which was created to make low cost loans to farmers through Industrial Development Bond (IDB) sales. The IFDA sells IDB's to private lending institutions in Illinois and turns around and loans that money to farmers at lower interest rates. These bonds are not guaranteed by the State of Illinois and are not an obligation of the State. The lending institutions get their own collateral from the farmers who borrow the money and this is their security on the IDB.

Our program is geared toward young farms who have a net worth of less than $250,000. We can loan money to purchase depreciable agricultural property (ex. breeding livestock, machinery equiment, confinement buildings, etc.) and real estate. We can loan $100,000/borrower for real estate.

H.R. 1635 would take away our ability to issue IDB's for real estate purchases. We feel this would hurt Illinois' farmers who are acquiring real estate through our program at low interest rates.

The majority of the young farmers we are making real estate loans for are first time land purchasers and we are giving the opportunity to them to make that purchase.

If H.R. 1635 passes these young farmers will have to borrow money for real estate purchases at conventional rates which most of them will have a hard time cash flowing.

Since December 1982 the IFDA has approved 474 loans for $21,729,293. Of those loans, 178 were for real estate purchases of $13,305,977.

We feel our program has helped these young farmers get their start into agriculture. The passage of H.R. 1635 in its present form would hurt young farmers in Illinois and other states who have similar young farmer programs. We would appreciate your cooperation on this matter.

WINSTON & STRAWN,
Washington, D.C., June 17, 1983.

Re hearings on the use of tax-exempt bonds.

JOHN J. SALMON,
Chief Counsel, Committee on Ways and Means,
Washington, D.C.

DEAR MR. SALMON: On behalf of the International Council of Shopping Centers, we wish to resubmit for the record testimony presented last year on tax-exempt financing. We believe the analysis contained in the testimony is pertinent to the committee's consideration with respect to the June 14 hearing.

We also believe that no further action should be taken on tax-exempt financing until the restrictions contained in TEFRA can be evaluated. Those restrictions are substantial in nature and should have a significant impact on the tax-exempt bond market. It would be a mistake to impose new restrictions before that impact is fully understood.

We ask that this cover letter be included in the printed record of the June 14 hearing together with the enclosed testimony.

Sincerely,

RICHARD MELTZER.

STATEMENT OF WALLACE R. WOODBURY, INTERNATIONAL COUNCIL OF SHOPPING CENTERS

SUMMARY

The members of the International Council of Shopping Centers (ICSC) believe that the current economic downturn requires the adoption of tax and economic policies which encourage and promote investment. The need for such policies is particularly acute in the real estate industry. The ICSC, therefore, urges that the proposal to restrict industrial revenue bond financing and the proposal to expand the limitations upon the deductibility of construction period interest and taxes be rejected and the current limitations upon the deductibility of construction period interest and taxes be repealed.

The ICSC maintains that IRB financing causes little, if any, net federal revenue loss while generating substantial federal, state and local income, sales and real estate taxes through the development, construction and operations of retail sales facilities.

Construction period interest is a legitimate business cash outlay and should be treated like other expenses of business. It is discriminatory to single out construction period expenses by denying deductions which are accorded all other business expenses.

I. Introduction

The International Council of Shopping Centers (ICSC) is a business association of approximately 10,000 members. These members are shopping center developers, owners, operators, tenants, lenders and others engaged in related business enterprises. ICSC represents a majority of the 22,000 shopping centers in the United States.

It is estimated that more than 5.9 million people are regularly employed in shopping centers and that several hundred thousand more are annually engaged in new construction. The rippling effect of shopping center development on employment in related businesses, including display advertising, maintenance and cleaning, legal and accounting, and the production and transportation of goods sold in the centers, is considerable.

II. Economic benefits of shopping center development

The extent of the contribution of shopping center development to the nation's productivity is not fully understood. Many people think of productivity solely in terms of the process leading directly to the manufacture of goods. Others would broaden the concept to include the distribution of those goods to the loading docks of the nation's retail facilities—but not to the distribution of products to the ultimate consumer. The fact is, of course, that retail facilities, as the final link in the chain of distribution, are an integral part of the productive process. Thus, to deny tax benefits to retailers but provide them to manufacturers or distributors is self-defeating and inconsistent since, without retail facilities, there can be no expansion of other links in the economic and production chain.

A. Employment. Shopping centers generate new jobs and secure existing jobs in a number of ways which represent tangible benefits to the community. Of course, the construction of a center provides employment to all sectors of the building trades. In addition, the ICSC has estimated that the tenants of shopping centers employ one full-time employee for every 400 to 500 square feet of gross leasable area space. Thus, a typical neighborhood or community shopping center of 175,000 square feet anchored by a soft goods store and a supermarket employs between 350 and 435 people. Moreover, many of these people, as recent entrants into the job market, would have been unemployable or marginally employable in industrial positions.

The increase in employment generated by shopping center development ripples through the local community as other businesses open or expand to provide the services for the new employees. Each new opening or expansion creates, in turn, new jobs and additional revenues.

B. Tax Revenues. It is difficult to dismiss the economic impact of shopping center development in local communities when one looks beyond abstract projections of sales and property tax revenues and considers the empirical data on the actual performance of shopping centers. Sales taxes and real property taxes are two of the largest sources of state and local revenue attributable to shopping centers. Other direct contributions to local treasuries include business license revenues and personal property taxes on such things as office and retail equipment and inventories.

For example, a 1975 study published by ICSC included a twelve-year case history of the fiscal impact of a large shopping center in Oak Brook, Illinois. The Oakbrook Regional Shopping Center is no more typical of the diverse facilities developed by ICSC members than any one shopping center can be. Nevertheless, the Oakbrook study suggests generally the powerful fiscal influence shopping centers can exert.

During the period from 1963 through 1973, the Oakbrook shopping center was the primary source of sales tax revenue for the Village of Oak Brook, Illinois. The shopping center's share of total municipal revenues ranged from a high of 91.3 percent in 1965 to 75.4 percent in 1973 (the last year for which the study developed data). Even after taking into account the very modest increase in municipal tax expenditures attributable to the shopping center's presence in Oak Brook (for example, increased police and fire protection and local road maintenance), the ICSC study found that in 1973 Oak Brook received net cash-flow benefits in excess of $1.2 million directly attributable to the shopping center. Without this net revenue source, the report concludes that Oak Brook would have experienced a deficit requiring either a decrease in expenditures or another income source. In fact, the local tax revenue generated by the shopping center allowed Oak Brook to maintain services without imposing a property tax for a number of years.[1]

III. Construction period interest and taxes—IRC section 189

Section 189 of the Internal Revenue Code, enacted by the Tax Reform Act of 1976, requires that a taxpayer other than a corporation (which is not a subchapter S corporation or a personal holding company) capitalize real property construction period interest and taxes. The amount capitalized may be amortized over a 10-year amortization period which was phased in and becomes fully effective as to commercial and industrial property in 1982 and as to residential property in 1984. Thus, although this provision has already had an adverse effect upon the real estate industry, the full impact of the provision has not yet been fully felt.

A. Capital Formation. The current law has the effect of draining capital from the real estate industry since interest and taxes are real, out-of-pocket expenses which have to be paid whenever due. By forcing individuals who develop real estate to capitalize these actual business expenses rather than allowing them to deduct them currently as others are allowed to do, section 189 diminishes the capital available for the development of real estate.

In addition, Section 189 is highly inflationary because, by increasing the capital required it increases the cost of development, and those who wish to construct a property must either abort the project or recover this increased cost of development through higher rents to lessees and higher prices to purchasers. In addition, businesses who lease, or who construct their own facilities, will pass these costs on to consumers through higher prices.

B. Equity. Section 189 is especially harmful to new and/or not-so-wealthy entrepreneurs, who do not have large amounts of capital and who must raise additional capital as a result of this provision. This burden is especially onerous at current high interest rates. Consequently, these entrepreneurs are discouraged or prevented from entering into otherwise viable housing and othe real estate developments or constructing new or expanded facilities for their businesses. Thus, Section 189 discourages competition and increases prices.

Repeal of section 189 will merely allow a dollar-for-dollar deduction of amounts actually paid as interest and taxes during the construction period, which is the time when capital is most needed, and will equalize the treatment of interest and taxes, which are actual out-of-pocket expenses, between real property business expenses and all other business expenses, none of which is subject to this onerous provision. The tax code currently treats the income from real property investments as business income, and it is inequitable to deny expense treatment to the costs which generate that income.

C. Recommendations. The administration has proposed extending this investment disincentive to all corporate taxpayers. In light of the adverse consequences which section 189 now has on most real estate development, we support the repeal of section 189 retroactive to its original effective date. Repeal of section 189 will equalize the treatment of interest and taxes, which are actual out-of-pocket business expenses, between the real estate industry and other business endeavors. Repeal also would remove the discrimination created by imposing this section against individuals and not against corporations which construct real property. Most importantly, repeal will encourage investment in productive real property, encourage expansion of current retail and manufacturing plant, and reduce rents.

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[1] Levin, Measuring the Fiscal Impact of a Shopping Center on its Community, page 30; International Council of Shopping Centers, 1975.

IV. Industrial revenue bonds (IRB's)

A. Role of IRB's in Shopping Center Development. As with other construction industries, shopping center development has in the past been dependent upon financing at rates which are consistent with affordable rents. Present market conditions have by and large dictated what we hope will provide to be a temporary end to conventional financing and, therefore, a temporary end to conventionally financed shopping centers.

The ICSC submits that the availability of industrial revenue bond financing, with the limited tax exemption afforded under Internal Revenue Code § 103(b), has allowed shopping centers and other commercial and industrial facilities to be built in communities that would otherwise remain without the clear social and economic benefits directly attributable to those facilities.

IRB financing has been crucial to the development of small and medium sized shopping centers of up to 200,000 square feet of gross leaseable area. These are the centers which represent the commercial heart of countless communities throughout the country, and they would have gone unbuilt but for the capital resources made possible (or at least more accessible) through IRB financing. The ICSC believes that the communities served by these facilities are economically better off today than they would have been without them. For example, in 1979, ICSC member M. H. Hausman Co., an Ohio developer of commercial facilities, built two shopping centers with industrial revenue bond financing. The company reports that neither of these facilities would have been built if the sole financing method available to the company had been conventional mortgages at prevailing interest rates.

Although the IRB rates and conventional rates have risen three to four percent since the facilities were built, a review of the income and expenses associated with one of M. H. Hausman's shopping centers illustrates the critical importance of IRB financing. The company's Columbia-Detroit shopping center in Westlake, Ohio, comprising some 50,000 square feet of gross leasable area, was financed through a $2.0 million IRB mortgage bearing an interest rate of 7½ percent.

As figure 1 shows, the annual debt service of $181,632 on the mortgage, combined with general and miscellaneous expenses, yields a net annual cash flow to the shopping center owner, after deduction from rental income, of $34,197. A 14 percent mortgage, on the other hand, would result in an annual debt service of approximately $289,000. That mortgage expense would, even with all other expenses remaining the same, produce an annual loss in excess of $74,000, and would therefore have dictated that the Columbia-Detroit shopping center not be built.

FIGURE 1

	IRB financing	Conventional mortgage financing
Income:		
Fixed rent	$220,176	$220,176
Expense:		
Mortgage	[1] 181,632	[2] 289,000
General expense—net recovery	3,800	3,800
Miscellaneous expense	2,400	2,400
Total expense	187,832	295,200
Net cash flow (loss)	34,197	(74,824)

[1] $2,000,000 principal amount, 7½ percent interest, 24-year term.
[2] $2,000,000 principal amount, 14 percent interest, 25-year term.

A similar analysis of income and expenses for the second of M. H. Hausman Co.'s IRB-financed projects reflects the same devastating effect of high mortgage interest rates. The Crossroads Plaza in Saybrook, Ohio, had more than 70,000 square feet of gross leasable area, and produced a net cash flow of $39,358. If H. H. Hausman Co had been unable to obtain the 7½ percent IRB-backed mortgage available at that time and been forced to proceed at the prevailing 14 percent mortgage rate, the positive cash flow would have been transformed into a net loss of $115,442 per year.

Of course, it might be argued that these illustrations show nothing more than that present market conditions justify higher rents to offset a developer's rising mortgage costs. As a practical matter, however, tenants of retail facilities are strictly limited in their ability to bear the burden of increased financing costs.

In deciding whether or not to lease space in a proposed shopping center, prospective tenants invariably focus on their projected return on investment. Although methods vary from one retailer to the next, analyses of returns on investment consider such factors as the estimated sales in the proposed facility, the expense of doing business, the anticipated profit, and a comparison of that profit to the total investment to be made in the new facility.

Clearly, rent is an important component of a tenant's expense of doing business. Thus, a proposed shopping center that cannot keep lease payments within the range required by a prospective tenant's return-on-investment analysis will not get built or will be delayed until interest rates fall to a level that will allow for rents which will permit the retailer to operate at a profit.

In the interim, people who could have been working will not be working, personal and business income taxes that could have been collected will not be collected, state and local taxes that could have been collected will not be collected, manufactured goods that would have been purchased and used will not be purchased, and so on.

The ICSC believes that these illustrations demonstrate that the net effect of eliminating or reducing the availability of small-issue IRB financing for retail facilities will be a substantial reduction of new construction starts in retail facilities. Concomitant with that reduction will be the loss to local treasuries of significant tax revenues. For example, the two relatively small shopping centers built by M. H. Hausman Co. discussed above are expected to generate total combined real estate and sales taxes of approximately $67,000 per year at full occupancy. Of course, that $67,000 is calculated without regard to the very significant local revenues arising out of increased employment (estimated at 240 to 300 new jobs) and the secondary development that may be spurred by the introduction of the new retail facilities.

B. Limitation Upon certain Uses of Small Issue IRBs. As previously indicated, any distinction between commercial and industrial uses of IRBs is counterproductive. Without a viable and healthy network of retail plant, no increase in manufacturing capacity will occur. Each segment of the economic system is interconnected and inadequate plant in one segment causes bottlenecks and blockages that ripple through the entire system.

The ICSC believes that IRB financing of shopping centers and other retail facilities contributes as much or more to both the economic wellbeing and quality of life of a community as does IRB financing of other links in the industrial and distribution chain.

For example, figures complied by the New Jersey Economic Development Administration demonstrate that, at least in that state, IRB financing for commercial projects is a more effective means of creating permanent jobs than all other uses of IRB financing. As figure 2 indicates, the number of permanent jobs created per $1.0 million of industrial revenue bond financing for commercial projects (including retail facilities) was approximately one/third higher than the number of industrial jobs generated by the same dollar amount of IRBs.

FIGURE 2

Project type	Total new jobs,[1] 1980	Total 1980 industrial revenue bonds issued in support of projects (dollars in thousands)	New permanent jobs per $1 million of IRB's
Commercial (including retail)	1,613	52,181.1	30.9
Balance of projects, excluding office and investment in quasi-public utilities	11,131	478,344.4	23.3

[1] Permanent (excludes construction).

Source: New Jersey Economic Development Administration, 1980 Annual Report 15–21

C. Federal Tax Revenue Impact of Small-Issue IRB Financing. The Department of the Treasury projects future revenue gains as a result of its proposal to limit IRB financing, although even the Treasury projects a net revenue loss in fiscal 1983. ICSC suggests that the results of a 1980 study conducted by Norman Ture, currently Treasury Undersecretary for Tax and Economic Affairs, more accurately states the effect of such limitations.

Ture pointed out that assumptions such as those made by the Department of Treasury are unrealistic since they presume that there are no changes in economic activity in response to the tax change. Thus, they erroneously assume that the volume of private investment would be unaffected by eliminating the IRBs because each eliminated dollar of IRB-financed investment would be replaced by a dollar of taxable financed capital outlay.

However, if the amount of IRBs were deemed to be associated with additional investment—that is, with investment which otherwise would not be undertaken—the initial impact revenue effect would be zero, since no displacement of other financing would have occurred. Taking into account changes in economic activity in response to the tax change and the effects of these changes in the economy on tax bases, additional IRB financing results in net additions to the volume of capital formation, rather than displacement of taxable financed investment.

Clearly, the experiences of ICSC's membership bear out Dr. Ture's conclusion that "IDBs are productive instruments for promoting economic development by making saving and investment more attractive to individuals and businesses. Their use results in overall gains in capital formation, employment, and output, rather than merely changes in the location of economic activity.[2]

The Congressional Budget Office ("CBO") also has projected additional federal tax revenues through the elimination of small-issue IRB financing. However, in testimony before the House Ways and Means Subcommittee on Oversight delivered on April 8, 1981, Roger C. Kormendi of the University of Chicago challenged certain assumptions upon which the CBO based its estimates of the net loss to the federal treasury associated with IRBs. Kormendi, in a report prepared with Thomas T. Nagle, concluded that the cost of IRB financing in lost federal tax revenues is $4 to $6 million for each billion dollars of new IRBs when taxable interest rates are between 10 percent and 14 percent. Kormendi's estimates contrast sharply with the CBO's estimates of $30 to $40 million for each billion dollars of bonds.[3]

Furthermore, Kormendi estimates that each dollar of interest saving for IDB borrowers costs the U.S. Treasury approximately 15 cents in federal tax revenues. Thus IRBs are more than six times as efficient as direct subsidies, which cost the U.S. Treasury one dollar for each dollar of benefit. This conclusion contrasts sharply with the Treasury's claim that each new dollar of interest saving for IDB borrowers costs the U.S. Treasury $1.33 in federal tax revenues.[4]

It is important to note that these estimates of revenue loss are not, as Ture would say, "net-of-feedback." Kormendi points out that tax revenues depend not only on tax rates but also on the tax base. Since anything that encourages the tax base to expand will result in a higher feasible level of tax revenues in the future, the lower capital cost provided by the interest tax exemption will almost certainly lead to more investment and growth of the small business sector. Therefore, sales, property, and income tax revenues will grow.

D. Evaluation of Small-Issue IRBs. The ICSC suggests that any decision to preserve or eliminate the tax exemption for small-issue industrial revenue bonds should be made solely on economic merit. The ICSC membership is satisfied that a legitimate cost-benefit analysis, considering all issues relevant to ultimate impact on the national economy, would dictate not only the preservation, but the expansion, of the present tax exemption.

If it is correct that minimal or no net loss to the federal treasury arises from the availability of small-issue IRB financing, no other legitimate policy consideration would be served by curtailing access to that source of capital. At the very least, it would be inappropriate for IRB critics to pursue some hidden philosophical goals, whatever those may be, disguised as a legitimate effort to reduce federal budget expenditures.

Moreover, the ICSC points out that imposition of new limitations at this time of extraordinarily high interest rates freezes out new entrants into the real estate industry, diminishes employment, and reduces markets for manufactured products.

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[2] N. Ture, A Report Prepared for the National Committee on Small Issue Industrial Development Bonds: Economic and Federal Revenue Effects of Changes in the Small Issue Industrial Bond Provisions 11 (1980).

[3] R. Kormendi and T. Nagle, A Summary of the Nature and Effect of Small-Issue Industrial Development Bonds 1 (1981).

[4] Id.

The ICSC suggests the American consumer and the real estate industry will both benefit by encouraging new development rather than by discouraging it.

In addition, the CBO's recent study reflects the diverse criteria among states for the appropriate uses of IRBs within their borders. So long as the federal interest in governing IRB use is as minimal as the net effect of IRBs on the federal treasury, ICSC believes that the federal government should decline to engage in efforts to impose uniformity on the states' exercise of their authority to issue IRBs. If individual communities and states, as major benefactors of the increased revenues attributable to commercial development, choose to encourage particular types of commercial and industrial development, their will need not and should not be supplanted.

E. Recommendations. It is clear, both from the CBO's acknowledgement of the inadequate data underlying its recent report and from the ICSC's own efforts to develop comprehensive information on the use of IRBs, that Congress cannot now be fully informed on the economic merits of IRB financing. The ICSC, therefore, recommends that reporting requirements be imposed at the state level on all users of industrial revenue bonds.

With respect to the specific proposals of the Administration, ICSC supports the requirement that a local elected official or legislative body approve the issuance of a bond and the requirement of a public hearing prior to such issuance. In addition, ICSC suggests that annual reports be required containing information on the amounts of IRB financing provided; the number of jobs created per million dollars of IRB issuance; wages, FICA taxes, and federal, state and local income taxes associated with these jobs; and property taxes and sales taxes generated by IRB-financed projects. ICSC is also prepared to meet with Members of Congress and the Department of Treasury to discuss excluding from IRB financing certain offensive uses.

The ICSC strongly believes that denying IRB financing to larger businesses totally misconceives the function of IRBs. They are not a subsidy to the developer or user but are intended to provide a community with economic development, increased jobs and tax revenues it would otherwise not enjoy. No matter how big or financially secure a corporation is, it has no incentive to invest in a particular community unless the deal will show a profit. IRBs are necessary to make the deals work in many communities, particularly those most in need of increased employment.

ICSC is very concerned, however, that the effect of other administration proposals will be to deny local communities the benefits of much needed facilities that depend upon IRB financing. In particular, the requirement of a local contribution imposes a financial burden on those hard pressed communities most in need of new investment. Similarly, the proposed small business limitation, to the extent it reduces investment and development, deprives local communities of the benefits of new investment.

Recently, the ICSC surveyed eleven of its members as to the effect of the small business limitation upon shopping center construction and operation. The members reported that the limitation would effectively prohibit the traditional anchor stores of small and medium shopping centers—groceries and drug stores—from participating in an IRB financed facility. Thus, communities would be the ultimate losers of such a limitation.

The requirements that facilities financed by tax-exempt bonds use straight line cost recovery methods and extended recovery periods for purposes of computing earnings and profits is particularly demaging since it substantially reduces the yield on investment to a degree which may make the entire project unfeasible. Finally, ICSC suggests that the arbitrage limitations and registration requirements result in additional and unnecessary costs to the developer and, with respect to the arbitrage limits, further suggests that the current law is adequate.

We generally recommend that the relative benefits of IRB financing are so great that Congress should encourage increased use of IRBs, whether through raised capital expenditure limits or other means, to finance commercial and industrial projects. ICSC submits that certain provisions of Internal Revenue Code § 103(b) have imposed inequitable and unnecessary conditions on the availability of IRB financing. The current $10 million capital expenditure limit applies, under § 103(b), to all facilities that are located in the same municipality or county and associated with the same principal user or users.[5] The jurisdictional limitation of § 103(b) should be modified to allow additional capital expenditures for industrial or commercial projects in areas where higher population would suggest a greater demand for those projects. The ICSC recommends, therefore, that the Congress respond to the needs of those populous communities by permitting higher capital expenditure limits in jurisdictions where population levels exceed a specified level.

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[5] I.R.C. § 103(b)(6)(E).

Finally, it is a particularly bad time to consider restricting the use of IRBs. All agree the economy is in a very serious recession and that the major program the Government has proposed to end the recession is increased investments from the private sector. Unfortunately, this plan is not working, and the President has identified high interest rates, as the reason. IRB financing offers the only escape valve that permits some development to continue at below market interest rates. In many places, IRB financing is "the only game in town." Restricting IRBs at a time when high interest rates are frustrating the economic recovery plan will serve only to worsen and prolong the recession.

STATEMENT OF THE IOWA FAMILY FARM DEVELOPMENT AUTHORITY

The Iowa Family Farm Development Authority (IFFDA) is pleased to have the opportunity to present a statement on H.R. 1635, a legislative bill introduced by Congressman Pickle and others to amend the Internal Revenue Code of 1954 with respect to the tax treatment of industrial revenue bonds. The provision in this bill which concerns the IFFDA relates to the termination of financing land purchases with industrial revenue bonds.

In 1981, Congressman Berkley Bedell, from Iowa, introduced H.R. 2977 in the Congress. This bill is known as the Beginning Farmers Assistance Act of 1981 and when Congressman Bedell introduced this bill in the Congress, he quoted from a report of the U.S. Department of Agriculture entitled "A Time to Choose". He said the report stated that today, in the United States, 1 percent of all landowners own 30.3 percent of the farmland, and 5 percent of the landowners own 48.1 percent of all farmland. Moreover, 69.5 percent of all farmland is owned by farmers 50 years of age or older. He further stated that only 5.9 percent of the total farmland acreage is owned by farmers age 35 and under.

These are interesting statistics and gives one pause to consider what the future might hold as it relates to farmland ownerhip in the United States. We are all aware that agriculture in these United States has been characterized by rapid change during the last four decades. The agricultural revolution, or perhaps it should be called evolution, has been described as one that has changed from a labor intensive to a capital intensive agriculture. Large farms are displacing thousands of small family farms as a result of this changing structure of American agriculture. There has been a trend to larger and fewer farms since the 1930's. This trend has been the subject of much debate by farmers, state and federal legislators and policy makers during the past 40 years. It is a subject that will continually dominate the thoughts of many in the agricultural community because it has both positive and negative effects on the structure of agriculture and the future of cities and towns of rural America.

During the history of this country, agriculture has divided itself into two primary categories. These categories include the small or part-time farmers who depend primarily on non-farm sources of income for economic options and full-time or commercial farmers who depend primarily on income from farming or ranching for economic progress. This latter group constitutes approximately 20 percent of the 2.4 million farms by number, but produces 80 percent of the food and fiber used by our nation and for export demands. When the situation is analyzed, it becomes evident that this latter group must be successful for agriculture to remain the "life blood of this nation".

Today, only 3.7 percent of our nation's labor force is involved in farm labor. Ninety-five percent of the total inputs are purchased from off farm sources. Farmers and ranchers need a lender who can provide a reliable source of capital because borrowed money is used to purchase most of these inputs.

The total U.S. Agriculture debt outstanding has increased dramatically over the past 10 years. It has been estimated by some people in agricultural finance that the total U.S. ag debt could grow to nearly $600 billion by the end of this decade. There should be no doubts in any of our minds about the fact that the future is going to be different for the farmer and rancher, and it is also going to be different for the organizations who are trying to provide them with the money that is needed for the capital items required in agriculture.

Capital for agriculture has been provided in many ways during the history of this country. Individuals, primarily through buyer-seller contracts, have traditionally provided the largest proportion of long-term credit to agriculture. They will continue to be a viable lender, however, they will find it more and more difficult to provide credit in the amounts and on the terms that meet their own needs and particularly the needs of the borrower. In addition to these individuals, there are several other institutions involved in agricultural credit. They include, but are not limited to, the Federal Land Bank, Production Credit Association, Life Insurance Companies, and the Farmers Home Administration. In addition, commercial banks have also served as a supplier of long-term credit, however, they have found it difficult to provide credit in the amounts needed because of limited lending funds and the growing demand for these funds. Commercial banks may be able to provide more credit if they can go to markets outside of their local communities to obtain funds and this is what probably will occur.

What is to happen at this point? Enter the new concept in agricultural finance which involves tax-exempt bonds. The use of tax-exempt industrial development bonds for agriculture is a new concept being tried in several states. Iowa and other states have enacted enabling legislation which creates state agencies to embark upon this new approach to agricultural financing.

When the 68th Iowa General Assembly was considering the legislation that was enacted in 1980 creating the Iowa Family Farm Development Authority, the following legislative findings were brought forth.

1. The establishment of the Authority is in all respects for the benefit of the people of the state of Iowa, for the improvement of their health and welfare and for the promotion of the economy, which are public purposes.
2. There exists a serious problem in this state regarding the ability of nonestablished farmers to acquire agricultural land and agricultural improvements and depreciable agricultural property in order to enter farming.
3. This barrier to entry into farming is conducive to consolidation of acreage of agricultural land with fewer individuals resulting in a grave threat to the traditional family farm.
4. These conditions result in a loss in population, unemployment and a movement of persons from rural communities to urban areas accompanied by added costs to communities for creation of new public facilities and services.
5. One major cause of this condition has been recurrent shortages of funds in private channels and the high interest cost of borrowing.
6. These shortages and costs have made the sale and purchase of agricultural land to beginning farmers a virtual impossibility in many parts of the state.
7. The ordinary operations of private enterprise have not corrected these conditions in the past.
8. A stable supply of adequate funds for agricultural financing is required to encourage beginning farmers in an orderly and sustained manner and to reduce the problems described in this section.

These findings served as the basis for the legislation that created the Iowa Family Farm Development Authority. There were additional findings, but these are the most relevant and they point up the fact that the Iowa General Assembly was concerned about the future of beginning farmers in the state of Iowa.

The IFFDA may participate in and cooperate with programs of the Farmers Home Administration, Federal Land Bank or any other agency or instrumentality of the federal government or with any program of any other agency in the administration of the beginning farmer loan program.

The eligibility requirements for a beginning farmer were set forth in the legislation that was enacted. Chapter 175, Code of Iowa, 1983, states that the beginning farmer is an individual with a low or moderate new worth who engages in farming or wishes to engage in farming. Low or moderate new worth is defined as the aggregate net worth of an individual and the individual's spouse and children, if any, of less than one hundred thousand dollars ($100,000). Other eligibility requirements include the following:

1. The beginning farmer must be a resident of Iowa.
2. The agricultural land and agricultural improvements or depreciable property the beginning farmer proposes to purchase will be located in the state of Iowa.
3. The beginning farmer must have sufficient education, experience, or training in agriculture.
4. The beginning farmer must have access to working capital, farm equipment, or livestock if the loan is for land. If the loan is for depreciable property (livestock and equipment) the beginning farmer must have access to working capital and agricultural land.
5. The beginning farmer must be unable to secure financing from conventional sources upon terms and conditions which he or she could be expected to fulfill.
6. The agricultural land, improvements, or depreciable property will only be used by the beginning farmer or his or her family.

There are other provisions and mechanics of the law, but this gives an indication of what is required to participate in the Iowa program.

It must be pointed out that IRS regulations provide that bond proceeds cannot be used to refinance existing debt or to finance working capital for the borrower. Also, bond proceeds cannot be used to acquire property from a related person. When farmland is being purchased with bond proceeds, the IFFDA follows IRS regulations with respect to the financing of a personal residence. The residence may be financed with bond proceeds when its value is clearly less than 5 percent of the amount of the loan for the farmland. If the value of the residence exceeds 5 percent, it becomes necessary for the borrower to finance the residence separately and without the use of bond proceeds.

In addition to the Beginning Farmer program, the IFFDA also conducts a Soil Conservation Loan Program to finance the construction of permanent soil and water conservation practices and no-till or minimum till planters. This program was enacted by the Iowa General Assembly in 1982 for the purpose of providing lower interest financing to Iowa landowners and operators who wish to use bond proceeds for the authorized purposes.

The Iowa law sets forth the maximum amounts that may be loaned by the IFFDA to qualified beginning farmers. They are:

1. Depreciable Agricultural Property totaling no more than $125,000 in value. Examples of depreciable property are livestock used for breeding purposes, farm machinery, etc. Feeder cattle, pigs or lambs do not qualify as depreciable property.
2. Agricultural Land and Agricultural Improvements totaling no more than $500,000 in value. Agricultural land is defined as land suitable for farming and which is or will be operated as a farm. Agricultural improvements include confinement buildings for swine, cattle or poultry, barns and other out buildings, grain storage facilities, silos, and improvements to the land (i.e., soil conservation).

The current program being utilized by the IFFDA to assist beginning farmers is called the Individual Agricultural Development Bond Program (IADBP). This program was begun in 1981 after it was determined that other programs would not be feasible. The program uses Industrial Revenue Bonds as the means to provide lower interest loans to qualified borrowers (beginning farmers). A bond is issued for each loan made; there are no aggregate issues utilized in the Iowa program. The first loan was closed in November, 1981 and as of June 15, 1983 a total of 189 loans have been closed (bonds issued), for a total dollar amount of $11,694,001.68. Since the program was initiated, 296 loan applications totaling $23,625,225.20 have been received and 288 loan applications have been approved totaling $21,252,443.20 with 3 loans being denied and 5 loans returned to the lender for additional information. It should be noted that as of June 15, 1983, a total of $14,239,655.95 had been requested for land loans and $6,923,916 was the total amount for land loans closed.

The bonds are being sold to participating lenders in the program and thus far the lenders have been commercial banks in the state of Iowa. There are 175 banks currently participating in the program.

This briefly explains the Iowa beginning farmer program. The IFFDA members and staff feel the program is conducted in a very responsible manner and is providing assistance to those qualified borrowers who cannot find lending assistance elsewhere.

The IFFDA recognizes the fact that Congress and the Administration are making serious efforts to reduce spending and not increase taxes. This is commendable and the citizens of this country applaud these efforts. However, it must also be recognized that young people need assistance in becoming established in agriculture because of the high costs of entering this business and the huge risks involved. A lower percentage of interest on borrowed money can make the difference between success and failure in agriculture today. The Iowa Beginning Farmer program can and does provide this much needed assistance by utilizing the use of Industrial Revenue Bonds. This should be viewed as an investment in the future because it is assisting those people who will ultimately become the food producers of this nation.

The provision in H.R. 1635 to deny the use of Industrial Revenue Bonds for the purchase of land would be very detrimental to the Iowa program. This program has been used by many people to obtain a loan for their first "piece of farmland" ranging from 20 acres in size to a few hundred acres. The average purchases generally range from 40 to 120 acres in size. Some farms have been larger, but are of lower price and are not considered to be "quality" farms. The Iowa law prohibits the IFFDA from funding corporations or partnerships, therefore, no funds have been made available to these entities for the purchase of farmland or other projects.

The question has been asked "why should Industrial Revenue Bonds be made available for agriculture?". An obvious answer to this question is that Industrial Revenue Bonds have been made available to industry and why shouldn't agriculture be given the same consideration. Again, the Iowa program targets those individuals borrowers with the lower net worth and as a result, is providing lending assistance that would not otherwise be available. Also, questions have been raised about limiting the use of tax-exempt bonds to beginning farmers and not to established farmers. The test for beginning farmers is that conventional financing cannot be obtained on a basis which they could reasonably be expected to succeed. Established farmers generally have access to conventional credit which is denied a lower net worth person (beginning farmer).

In all instances in the Iowa program, the beginning farmers have been denied conventional financing. These denials have come from commercial banks, the Federal Land Bank, Production Credit Association, Insurance Companies and the Farmers Home Administration. The denials were given for a variety of reasons, but generally, the conventional interest rate was too high for the person to succeed or for a lack of adequate security or collateral.

The tax-exempt bond program has filled a void and provided an opportunity for many beginning farmers in Iowa to obtain borrowed capital for their farming operation that would not have been availabe from conventional sources.

CONCLUSION

The IFFDA would urge Congress to retain the use of industrial revenue bonds for beginning farmer programs including the purchase of farmland. Rather than completely eliminating the use of tax-exempt bonds for the purchase of farmland, it would be advisable to consider alternatives that would eliminate the abuses the sponsors of H.R. 1635 feel occur in industrial revenue financing. The following tests for the purchase of farmland might be applied:

First Purchase-Capital Expenditure Test. In reviewing the individual beginning farmers assisted by the Iowa program, and in exploring other restrictions found in the Internal Revenue Code dealing with tax-exempt financing, we would suggest a test which comprises all or part of the following:

1. First Time Farmland Purchase Test. Financing would be restricted to the first time acquisition of agricultural land by the user. The agricultural unit could be defined, at least for the Iowa purposes, as agricultural land of 10 acres or more. The first time user concept is also incorporated in the Ullman Bill relating to mortgage subsidy bonds, now codified in IRC Section 103A.

2. Capital Expenditure Test. A second simultaneous test could be a capital expenditure test. As the program tends to target individuals in the process of starting farming who need assistance, one of the tests should relate to financial ability. A test presently incorporated in Section 103 of the Internal Revenue Code relating to industrial revenue financing is a capital expenditure test. We would suggest that financing be available only to individuals who have not expended more than $500,000.00 (this amount could possibly be lower) of capital expenditures in the three years preceding the date of issuance of the bonds. This test can be substantially monitored from filed Form 1040's. This test in tandum with the first time agricultural land purchase test (the acquisition of land not necessarily showing on a 1040) would target the individuals contemplated by the Iowa legislation.

3. Engaged in Farming Test. The third test to be applied simultaneously with the foregoing two would be that the financing only be available for an individual actually engaged in farming. This would substantially eliminate the investor purchasing farmland for the first time. It further targets the federal legislation to the same group the Iowa Legislature determined needed assistance, namely individuals desiring to actually engage in farming. The experience of the Iowa program has been that an individual purchasing farmland for the first time to actually personally farm, has usually been involved in farming for at least a nominal period of time on rented land, in a sharecropping situation or otherwise. In fact, the Iowa program specifically stated that the individual must have prior farming experience. This test could be monitored by requiring that a borrower have previously filed a Schedule F in conjunction with Form 1040.

The Iowa Family Development Authority wishes to thank the members of the Committee for the opportunity to comment on H.R. 1635. If the agency can be of further assistance to the Committee, it stands ready to respond to your inquiries.

STATEMENT OF S. LANE GENATOWSKI, VICE PRESIDENT, KIDDER, PEABODY & CO., INC.

INTRODUCTION

I am S. Lane Genatowski, a Vice President of the investment banking firm of Kidder, Peabody & Co. Incorporated. My main area of professional involvement is public finance. I am the Managing Officer of the Corporate Services Group within Kidder, Peabody's Public Finance Department. In that capacity, I am responsible for all tax-exempt financings on behalf of Kidder, Peabody's corporate clients.

Kidder, Peabody & Co. Incorporated was founded in 1865 and was incorporated in 1965. All stockholders but one are full-time employees. Kidder, Peabody employs approximately 4,700 persons, including more than 1,400 registered representatives, who staff both domestic and international offices.

In an industry that has been quite volatile, Kidder, Peabody has been consistently profitable for more than 40 years. It's hallmark has been not only it consistent profitability, but also its financial stability. Today, Kidder, Peabody benefits from a capital base in excess of $140,000,000. This capital consists primarily of equity and is allocated to the fundamental aspects of investment banking, thus giving Kidder, Peabody a strong, high quality capital base.

Kidder, Peabody, in 1966, was the first major investment banking firm to banking firm to establish a separate, full service public finance department. Over the past twelve years, Kidder, Peabody has been consistently ranked within the top ten managers of negotiated revenue bond issues each year according to Securities Industry Association and Public Securities Association Statistics. In the first quarter of 1983, Kidder, Peabody ranked sixth overall in negotiated underwritings of tax-exempt financings with 48 financings for $622,187,000.

POSITION

During the present period of economic recovery, relatively high interest rates and unemployment, it is surprising that the Congress would seriously entertain major cutbacks in the use of tax-exempt securities to finance pollution control. In fact, it would be poor national policy in light of one, last year's restrictions in this area; two, the current consideration of proposed modifications to the Clean Air and Water Acts; three, contemplation of legislation to deal with acid rain; and four, the growing hazardous waste problems faced by the nation. Tax-exempt financing is the only meaningful method to finance capital expenditures for the control and abatement of pollution. For this reason, the public nature and desirability of such financings has long been recognized by Congress.

We agree with the original concept of the 1968 legislation—that no statutory exemption be available for industrial development bonds except where the proceeds of such bonds are used to finance socially or economically desirable projects on the basis of community benefit. The Pickle bill, rather than addressing specific areas that could be considered abusive, broadly attacks tax-exempt financings as a whole. This approach would result in an increase in the costs of many nonproductive environmentally mandated projects. The resultant increases would diminish capital for job producing projects and accelerate the costs of services and products; additionally, it is predictable that a reduction in current law benefits will cause delays in retrofitting plants and the construction of new facilities.

The balance of this statement will specifically address the ramifications of restricting financings in areas where there have been no abuses and where there are strong public policy reasons for continuing [the] existing [IDB] provisions.

PICKLE PROPOSALS—POLLUTION CONTROL

Pollution control expenditures are for nonproductive government mandated facilities which have an obvious benefit to society but not to productivity. These expenditures are public in nature, and clearly should not be subject to any further restrictions. The impact of such restrictions would be particularly detrimental to basic industries such as steel, auto, paper, and utilities—all of which are just beginning to come out of an economic downturn.

H.R. 1635 would restrict industrial development bond financed property to straight line depreciation over an extended life; passage would constitute, unfairly, a further repeal of ACRS. It should be noted that no concern was raised that ACRS would provide undue benefits in the context of tax-exempt financings when ACRS was adopted in 1981. Nevertheless, TEFRA imposed a contraction of ACRS benefits for some pollution control financings. Kidder, Peabody testified last year that Congress unfairly was using a slight-of-hand reduction in ACRS. To repeat that performance in 1983 would be arbitrary. Tax incentives in this area continue to be appropriate in light of the nation's environmental policy. Because public purposes continue to exist, tax-exempt financing should continue and thus, the Pickle proposal makes no sense.

The Internal Revenue Service has already been overly restrictive in its interpretation of section 103(b)(4)(F) of the Internal Revenue Code. The law should be amended to make it clear that the most modern and efficient methods for pollution control qualify for tax-exempt financing, rather than restricting such financing to "end of pipe" technology. In addition, the formulas used for ascertaining economic benefit from such financings shoud be modified to insure that the costs and expenses of operation are properly accounted for before the financing is reduced. Finally, there is no justification for the Internal Revenue Service position which virtually eliminates financing of hazardous waste treatment facilities. At a time when we are trying to revitalize both our economy and our environment, there is no logic in restricting financings in this area. Moreover, restricting tax exempt financing for environmental facilities ignores the fact that this is the only meaningful incentive in the Code for this type of activity. Finally, the accomplishments to date in this area are based largely upon this financing device.

SEWAGE, SOLID WASTE, AND WATER FACILITIES

The disposal of sewage and solid waste and the furnishing of water are clearly public functions. It is difficult to conceive that anyone would consider disposing of sewage and garbage as other than a public purpose. The need for tax-exempt financing in this area is particularly exacerbated by the need for and requirements of environmentally safe systems. Environmental standards have placed a tremendous additional cost on waste disposal and have forced communities to consider new, higher cost technologies. For example, landfill for garbage is being replaced by mass burn facilities which have the added benefit of producing energy and recapturing valuable metals. Such facilities serve many socially desirable goals, but will not be feasible without tax-exempt financing due to the tremendous capital required to construct them. If the bill were adopted, local governments would bear increased costs because debt service requirements constitute a major element in establishing the necessary tipping fee which is charged by private enterprises in providing their services to a community. Passage of the bill would force most communities to consider owning plants in this area. Ironically, under current Internal Revenue Service interpretations, even community ownership does not prevent the debt instruments from being classified as industrial development bonds. Accordingly, these communities would be faced with the hardship of the 90/10 test so a portion of the cost (electrical generation) may be subject to taxable obligations. More important, the community will lose the benefit of a government obligation rating since the debt instruments will be industrial developments bonds.

TRANSPORTATION FACILITIES

Another area of obvious public concern is section 103(b)(4)(D) of the Internal Revenue Code permitting financing of docks, wharves, and mass commuting facilities. Congress, as recently as 1981, recognized the need for tax incentives for mass transportation facilities when it created a special rule in the safe harbor leasing area. These facilities benefit the public and are essential to the economy. For example, the major need for improved port facilities for the shipment of coal and other items is widely recognized.

EXEMPT SMALL ISSUES

This is the primary area where abuses are alleged. Some further reduction in such financings may be warranted. However, the bill's restrictions of small issues on the basis of a $20 million capital expenditure test is overly restrictive. Kidder, Peabody supports legislative reform but perceives the proposal would, in many cases, eliminate proper utilization of industrial development bond financings.

GENERAL

The Pickle bill incorporates many of last year's recommendations of the Oversight Subcommittee of the Ways and Means Committee which were repudiated. Additionally, the bill adopts many of the provisions adopted by the Committee on Finance last year, which the Senate rejected. The thrust of the bill, which reduces current law benefits because of revenue loss, belies the Economic Analysis Concerning The Revenue Estimates of Pollution Control Financing prepared for the Council of Pollution Control, Financing Agencies by Data Resources, Inc. and Coopers & Lybrand.

Finally, Press Release No. 8 suggests a per state limitation. Such a rule for pollution control financing can best be described as a paradox for there is no correlation between the number of people in a state and compliance with Federal environmental statutes.

CONCLUSION

Assuming Congress further eliminates the socially less beneficial industrial development bond financings and restricts abusive small issue financings, there is no rationable for the broad rules set forth in H.R. 1635. Briefly, the exempt activities that have an inherent social benefit or that provide quasi public projects should continue under existing law. Kidder, Peabody supports true tax reform but believes Congress should not overlook the continuing need for tax-exempt financing for the benefit of valid public purposes.

STATEMENT OF JAMES O. ROBERSON, SECRETARY, MARYLAND DEPARTMENT OF ECONOMIC AND COMMUNITY DEVELOPMENT

The Maryland Department of Economic and Community Development is one of thirteen principal cabinet agencies of Maryland state government. Charged with encouraging economic and community development, we have extensive experience in the use of small issue exemption industrial development bonds (IDBs).

H.R. 1635 would have a significant impact on the use of IDBs through extending the depreciation schedule(s) for assets financed by IDBs, by prohibiting land acquisition from being financed by small issue IDBs and by defining "large businesses" prohibited from using IDBs. We oppose H.R. 1635 as being untimely and placing unnecessary restrictions on the use of IDBs.

Before commenting on the specific provisions of H.R. 1635, we question the propriety of such significant legislation in light of the major changes made to the law under the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982. Besides sunsetting small issue IDBs as of December 31, 1986, reporting and public hearing requirements and restrictions on eligible activities were added to the law. It would appear that the appropriate response of the Congress would be to review the entire subject of small-issue IDBs, presumably in connection with the 1986 sunset, after there has been a reasonable opportunity for the TEFRA changes to take effect. TEFRA was meant to address certain perceived abuses in the use of small issue exemption IDBs and time should be allowed to see if TEFRA adequately addressed these perceived abuses. Congressional action so soon after TEFRA would make a mockery of the extensive work done on both sides of the issue in fashioning the IDB provisions in TEFRA. Let's see if the present medication is working before prescribing further medication, some of which would be lethal.

The most critical provision of H.R. 1635 is that dealing with the depreciation schedule for assets financed by IDBs. H.R. 1635 would retain the TEFRA requirement of using straight line depreciation but would extend the depreciation period. As an example, real property or buildings would be depreciated on a straight line method for 25 years rather than on a straight line for the accelerated cost recovery system period (10 years). Offered under the guise of reform, this provision would totally preclude the use of IDBs. Any financial or economic analysis would clearly demonstrate that the use of the extended depreciation period would more than offset the interest savings from IDB financing. If it is the intent of Congress to abolish IDBs, it would be better for Congress to do this directly rather than use the subterfuge of this provision in H.R. 1635.

Another disturbing provision of H.R. 1635 would increase the so-called $10 million exemption to $20 million but would change its determination from a political jurisdiction basis to a world-wide basis. We are concerned that this provision would adversely impact Maryland's attempt to attract foreign investment in plant and equipment. Applying a world-wide basis to foreign firms would probably preclude their eligibility for the lower interest financing of an IDB as an incentive to locate their plants in the United States. At a time when many American jobs are being lost to foreign competition, it would be ironic for the Congress to remove a significant incentive to bring these plants to the United States and employ American workers.

The prohibition against the use of small issue IDBs for the acquisition of land causes as much puzzlement as it does concern. If the purpose of this provision is to prohibit land speculation, then it is a serious case of overkill. Maryland law, like that of most other states, requires that the issuing public body make a determination of economic impact. This determination is usually based on job creation which is usually not the case with pure land acquisition projects. If the purpose is to limit IDBs so that a borrower can only use IDBs for buildings and equipment, then it is a shortsighted provision that will complicate the financing and possibly make projects financially unfeasible. This provision does not deal with any abuses, but merely serves to discourage and complicate economic development requiring IDB financing.

In closing, it is important that the Congress not be shortsighted in its evaluation of IDB legislation. The long-term and overall economic benefits must not be overshadowed by a narrow examination focusing on tax policy and immediate revenue loss to the Federal Treasury.

It is interesting to note that on the same day that the Ways and Means Committee will hold hearings on H.R. 1635, it will also hold hearings on H.R. 1176—a bill to remove the December 31, 1983 sunset on mortgage revenue bonds (MRBs). The broad based effort to repeal this sunset results from the adverse impact that will result from the abolishment of MRBs. Both TEFRA and the Mortgage Subsidy Bond Tax Act of 1980 (incorporated in the fiscal year 1981 Budget Reconciliation Resolution) were enacted without due consideration of their impact on the housing industry and the provision of homeownership opportunities for moderate income families. Therefore, H.R. 1176 has been introduced to remedy this oversight.

Finally, while the Congress is justifiably concerned about the Federal government's immediate revenue needs, it is important for the Congress to realize that the short-term revenue loss to the Federal government for small issue IDBs is shared by state and local governments.

State of Michigan,
Department of Agriculture,
Lansing, Mich., June 20, 1983.

Subject: H.R. 1635.

Mr. John J. Salmon,
Chief Counsel
Committee on Ways and Means, Washington, D.C.

Dear Mr. Salmon: The Michigan Family Farm Development Authority (Authority) was established by the Michigan Legislature in 1982 to assist qualified beginning farmers to continue or commence farming through issuance of low-interest loans. The source of funding for these loans is Industrial Development type bonds issued by the Authority.

Because 60–65 percent of these loans will be for the purchase of agricultural land, the Authority strongly opposes provisions of HR 1635 which would eliminate land purchases with proceeds of Industrial Development bonds.

The keystone of Michigan's agriculture industry is family-type ownership. The vast majority of the more than 50 food and fiber crops produced commercially in the state are especially adopted to family-type farm ownership.

Studies show that more than 35 percent of Michigan's farmland is owned by people 55 years and older indicating that approximately 3 million acres will change ownership in the coming decade. Because of high investment and interest costs, many beginning farmers are not in a position to purchase these family-type operations when they become available; the Authority's low-interest loans provide that opportunity. Elimination of the use of Industrial Development bond revenues for real estate purchases would adversely affect the ability of 6,000–8,000 beginning farmers to become established in farming.

Michigan's program has, by legislation, established maximum net worth for loan eligibility and set practical loan limits for agricultural land, thus assuming that loans are based on need.

With Michigan's economy in its present depressed state, agriculture is our one stable growth industry. The Authority programs, utilizing Industrial Devolpment bond revenues to provide low-interest loans, are vital to maintaining our viable agriculture. We strongly urge that HR 1635 be rejected by the Committee.

Sincerely,

Donald J. Schaner,
Executive Director,
Michigan Family Farm Development Authority.

Mortgage Bankers Association of America,
Washington, D.C., June 16, 1983.

Hon. Dan Rostenkowski,
Chairman, Committee on Ways and Means, Washington, D.C.

Dear Mr. Chairman: This letter is submitted in connection with the hearings on tax-exempt revenue bonds held by the Committee on June 15 and 16, 1983. MBA appreciates the opportunity to comment upon the exemption from Federal income tax for interest paid on revenue bonds for housing and we respectfully request that this letter be included in the hearing record. Section 103A of the Internal Revenue Code provides that this exemption for such bonds will expire on December 31, 1983. MBA favors amending the law to continue the exemption, provided the proceeds from the sale of revenue bonds for housing are targeted toward the disadvantaged, that is, low-income families, the elderly, and the handicapped. MBA also believes that all revenue bond programs should allow participation by all types of mortgage originators and servicers.

The Mortgage Bankers Association of America is a nationwide organization devoted exclusively to the field of mortgage and real estate finance. MBA's membership is comprised of mortgage orginators, mortgage investors, and a variety of industry-related firms. Mortgage banking firms, which make up the largest portion of the total membership, engage directly in originating, financing, selling, and servicing real estate investment portfolios.

Mortgage bankers have participated extensively in homeownership programs financed with the proceeds of tax-exempt revenue bonds. When properly administered and properly targeted, revenue bond programs can provide homebuyers with needed financing and mortgage lenders with a new source of business opportunities, without infringing upon markets that can be served without government subsidy.

MBA opposed the use of municipal tax exempt revenue bonds to fund home ownership when such bonds mushroomed in 1978. The rapid proliferation of these bonds for home mortgages allowed the substitution of public funds for private funds in the marketplace. In addition, they were an inefficient way to deliver governmental help even to those in our society who could not be served adequately by private lenders. Others, too, saw the danger of the apparently limitless use of home mortgage revenue bonds, and in the Mortgage Subsidy Bond Tax Act of 1980, (Subtitle A of the Revenue Adjustments Act of 1980, Title XI of the Omnibus Reconciliation Act of 1980. PL 96-499), Congress provided that the tax-free status of such bonds would expire at the end of 1983.

The Mortgage Subsidy Bond Tax Act of 1980 not only established an expiration date in the future; it imposed other restrictions to be effective until that expiration date. A statewide ceiling was set on the volume of bond issuances; a one percent arbitrage limit was imposed; only first-time homebuyers could be financed, and, the maximum purchase price that could be paid using tax-exempt financing was set at 90 percent of average for the area (110 percent in areas of special need). The practical result of these interim restrictions was to prevent the issuance of tax-exempt revenue bonds for housing almost immediately, long before the established December 31, 1983 expiration date.

Recognizing that the restrictions imposed in 1980 were too tight, Congress included provisions in the Tax Equity and Fiscal Responsibility Act (TEFRA) (PL 97-248) to ease the limits. The arbitrage limit was increased to 1.25 percent; the first-time homebuyer rule was given a 10 percent safety exclusion; and the sales price limits were raised from 90 percent to 110 percent of average acquisition cost for the area (120 percent in targeted areas).

The experience of bond issuance under these restrictions indicates that revenue bonds for housing can be used successfully with limits. The limits established by the 1980 Act, as modified by TEFRA, may need further tuning to achieve the proper balance between high volume and targeted benefits, but the recent history of the bonds indicates that their use can be controlled and their implicit Federal subsidy can be directed to those who cannot be adequately served by the private market.

Reflecting this recent history, MBA no longer opposes categorically the issuance of home mortgage revenue bonds. Rather, on May 17, 1983, the Board of Governors adopted a revised statement of policy on the subject of tax exempt bonds for housing, as follows:

"MBA supports using municipal tax-exempt bond issues to provide funds for home mortgages, provided such issues are targetted toward meeting the needs of the disadvantaged, that is, the low-income, the elderly, and the handicapped. Further, such programs should be simplied and strict standards applied to make them less costly to homeowners and easier to work with for all participants. Moreover, if used, such programs should only be available to housing finance agencies which allow all types of originators and servicers to participate in all their programs."

Therefore, MBA supports enactment of H.R. 1176, The Housing Financing Opportunity Act of 1983, introduced by Representatives Thomas J. Downey, Bill Frenzel, and many cosponsors. This legislative measure simply would delete the tax exemption expiration date from the Internal Revenue Code by restating Section 103A(b) without the expiration clause. It would not ratify or otherwise endorse the current purchase price ceilings, nor preclude subsequent fine tuning to target the proceeds from revenue bonds toward encouraging homeownership by the disadvantaged, that is, people with relatively low income, or who are elderly or handicapped.

Preliminary findings of a study being conducted by the General Accounting Office (GAO) raise a question whether revenue bonds for housing are currently restricted so as adequately to target the proceeds to disadvantaged persons. In its April 18, 1983 report to the Chairman of the Senate Finance Committee, "The Costs and Benefits of Single-Family Mortgage Revenue Bonds: Preliminary Report," the GAO found "that most subsidized home loans were not made to low- and moderate-income households in need of assistance, but rather to those who probably could have purchased homes without assistance." (page 3). Whether the final report will reach the same conclusion remains to be seen, of course, but, if the study does result in evidence that the Federal tax exemption is being used widely for people who would be excluded from direct Federal subsidy programs, a careful adjustment of the Federal law should be made.

In reviewing the final results of the GAO study, observers should be aware that it was conducted on activity occurring during 1981 and 1982—a period of record increases in home mortgage interest rates and market distortions brought about by these increases, as well as the high rates actually reached. Because of the rapid increase in the price of financing, the private market was accessible only to a few. Now that home mortgage interest rates have dropped to more normal levels, the private market is again serving moderate-income homebuyers and a more normal economic environment exists. Whether the states generally will exercise restraint and offer tax-exempt revenue bond assistance only to those disadvantaged people who cannot be served by the private market may not be answered by the study results alone.

MBA appreciates the opportunity to express its views, and would be pleased to furnish any additional information that may be needed.

Sincerely,

James M. Wooten,
President.

Statement of the Municipal Finance Officers Association

INTRODUCTION

Mr. Chairman, this written statement is submitted in lieu of an appearance by the Municipal Finance Officers Association (MFOA) at the Committee on Ways and Means' hearings on trends in municipal financing and the use of tax-exempt bonds to finance private activities. The Municipal Finance Officers Association was unable to send a witness to the hearings because of a scheduling conflict with the Association's Annual Meeting in Toronto, Ontario, Canada.[1] We are pleased, however, to have an opportunity to provide you with our assessment of recent trends in the tax-exempt bond market and would be happy to respond to any questions you may have.

As in years past, we must report to you that the tax-exempt bond market continues to deteriorate and, as a result, there is further erosion in the value of tax exemption for state and local governments. While states and localities share the difficulty of high interest rates with all other sectors of the economy, the state-local sector has experienced special conditions that have exacerbated its borrowing problems. Additional factors affecting the tax-exempt interest rates are the large volume of private-purpose, tax-exempt borrowing and federal tax code changes that have reduced investor demand for tax exempts.

Because of the current condition of the municipal bond market, the Municipal Finance Officers Association continues to strongly support federal efforts to curb the issuance of small-issue industrial development bonds and urges the Congress to consider carefully any future tax code changes which will further impair state and local governments' ability to raise needed capital. In this statement, we provide an update on trends in the tax-exempt market, express our concerns over the proliferation of small-issue, conduit industrial development bonds and provide the Committee with an explanation of the Municipal Finance Officers Association's new mortgage revenue bond policy.

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[1] Questions concerning this statement should be directed to Catherine L. Spain, Director, Federal Liaison Center, Municipal Finance Officers Association, 1750 K St., N.W., Suite 200, Washington, D.C. 20006, (202) 466-2014.

CHANGES IN THE MUNICIPAL BOND MARKET

In a recent publication on capital financing for state and local governments, John E. Petersen identifies a combination of cyclical and secular factors that have brought rapid and radical changes to the tax-exempt market over the past few years.[2] In addition to the high interest rates and recessionary climate noted above, Petersen cities the simultaneous changes in the federal tax code, reductions in the federal budget and the impact of recession on government revenues as causes for change in the municipal bond market.

To these changes, which reduce investor demand for tax exempts while making access to the market more important, are added the pressures brought by a restrictive monetary policy and the continuing growth in private-purpose, tax-exempt borrowing. According to Petersen, the latter swelled the supply of tax-exempt securities in the midst of weak demand for such securities.

The pressures in the tax-exempt market are typically measured by comparing its cost of capital to that in the taxable market. Over the past two years, the borrowing costs for state and local governments have risen faster than interest rates in other sectors of the economy. As seen in the following table, tax-exempt interest rates shifted from a historic range of 65 to 70 percent of comparable taxable bond yields up to 80 to 85 percent in late 1981 and early 1982.

The deterioration of the tax-exempt market is further evidenced by the fact that between 1979 and early 1982, yields on new issues of long-term state and local debt rose nearly twice as much on a percentage basis as yields on long-term corporate and Treasury debt.[3] Writing in the Federal Reserve Bank of New York's quarterly periodical, David Beek estimates that approximately one half of the increased financing costs for state and local debt reflects the general increase in all interest rate levels over the past few years.

LEVELS AND RATIOS OF INTEREST RATES: BOND BUYER 20 BOND INDEX (TAX–EXEMPT), MOODY'S ALL-INDUSTRY CORPORATE BONDS (TAXABLE) 1978 TO 1983/I

Year/quarter	Bond buyer 20 bond index (tax-exempt) (pct.)	Moody's all industry corporate bonds (taxable) (pct.)	Ratio of tax-exempt to taxable (pct.)
1978 (yr.)	6.07	9.07	66.0
1979 (yr.)	6.53	10.12	64.5
1980/I	8.56	12.80	66.9
1980/II	7.86	12.32	63.8
1980/III	8.79	12.30	71.5
1980/IV	9.61	13.67	70.3
1981/I	9.97	14.09	70.8
1981/II	10.68	14.89	71.7
1981/III	12.03	15.65	76.9
1981/IV	12.59	15.64	80.5
1982/I	12.96	15.95	81.3
1982/II	12.19	15.55	78.4
1982/III	11.06	15.03	73.6
1982/IV	10.14	13.49	75.2
1983/I	9.41	12.88	73.1

Source: Resources in Review, Government Finance Research Center, Municipal Finance Officers Association.

The remaining half is caused by other factors affecting the municipal bond market.[4] Following are descriptions of these other factors.

Changes enacted in the Economic Recovery Tax Act of 1981 (ERTA) have contributed to systematically higher interest rates for municipal bonds compared to those on taxable securities. Several provisions in ERTA that affected individual taxpayers and had adverse impacts on tax-exempt interest rates are:

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[2] John E. Petersen and Wesley C. Hough, Creative Capital Financing (Washington: Government Finance Research Center, 1983) see Chapter 3, "Recent Trends in the Tax-Exempt Securities Market," pp. 11-20.

[3] Salomon Brothers, An Analyatical Record of Yields and Yield Spreads (New York: Salomon Brothers).

[4] David C. Beek, Quarterly Review (New York: Federal Reserve Bank of New York) p. 30.

The reduction in personal income tax marginal rates, especially the lowering of the top bracket from 70 percent (on unearned income) to 50 percent for all income.

The associated reduction in the capital gains rate, which will drop from a maximum of 28 percent to 20 percent, thereby improving the attractiveness of equity holdings in relationship to fixed-income securities.

Expansion of income-sheltering opportunities in individual retirement savings plans (IRA and Keogh).

Partial exemption of interest income and indexation of marginal tax brackets, commencing in 1985.

The creation of the All Savers Certificate which has resulted in a superior tax-exempt, short-term instrument that is federally guaranteed.

Looking at corporate purchases of municipal bonds, the following provisions in the 1981 tax law have had adverse impacts: expansion of leasing tax shelters, increase in the investment tax credit (ITC), and accelerated depreciation schedules which, along with the ITC, will both enhance the rate of return on alternative investments and lessen the need for tax shelter from municipal securities. Expansion of these opportunities may prove to be especially significant in further reducing commercial bank demand for municipal securities.

The Tax Equity and Fiscal Responsibility Act of 1982 further changed the status of municipal securities. Two provisions that are likely to exert an upward push on municipal market rates are:

The partial removal of the deductability of bank interest costs used to finance the purchase of tax-exempt securities.

The new requirement that all municipal bonds issued after July 1, 1983 be in registered form, causing a "two-tiered" market for municipal debt.

Looking at the demand for municipal bonds, there were several negative trends which have been evident over the past two years. Demand for tax-exempt bonds by institutional investors, namely commercial banks and casualty insurance companies, practically evaporated. Correspondingly, individuals (including mutual funds) acquired two-thirds of all state and local debt last year and, most recently, purchased 80 percent of the new municipal issues.[5] Commercial banks and fire casualty insurance companies—which in the late 1970s acquired 80 to 90 percent of net increases in municipal bonds—have shown only minimal interest over the past few years. This pattern of demand illustrates the critical importance of the individual investor to the municipal securities market, and the higher yields which are necessary to attract these individuals to purchase municipal bonds.

On the other side of the ledger, there will be increased pressure on our governments to borrow funds, because of the cutbacks in federal grant-in-aid and those proposed in the current federal budget. For example, federal grants over the last decade have financed approximately 37 percent of all state and local construction spending. Sharp reductions in those grants will require increased borrowing if the projects are to go forward. The tax-exempt bond market simply cannot accommodate this increased public-purpose borrowing with the high level of private-purpose borrowing that is projected in the next five years.

For the above reasons, the long-term prognosis for the tax-exempt bond market is not good. This is not to say that tax-exempt interest rates will not drop when other rates drop, but rather, in relationship to taxable rates, they will remain at much higher levels than we have seen traditionally. States and localities will continue to pay substantially more in interest expense on their new borrowings than they did just five years ago.

The dimension of this interest cost problem is illustrated by a calculation performed by Beek in this analysis of the tax-exempt market for the Federal Reserve.[6] He projects that the additional annual interest costs on bonds issued in 1981 due to the higher ratio of tax-exempt to taxable yields (higher than 60 percent) was $1.1 billion, or $22 billion over the approximate twenty-year life of the bonds.[7]

The changing condition of the tax-exempt bond market has presented a financing crisis for states and localities and provided the stimulus for the varieties of creative financing instruments that have become so popular lately.

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[5] Federal Reserve, Flow of Funds.

[6] Beek, p. 33.

[7] The analyst chooses .60 as a benchmark yield ratio. It represents a theoretical relationship between taxable and tax-exempt yields in a perfect market where the market's yield ratio would equal 1.0 minus the marginal tax bracket of the marginal investor.

INDUSTRIAL DEVELOPMENT BONDS (IDB'S)

The Municipal Finance Officers Association has testified before Congress on a number of occasions in opposition to the use of tax-exempt bonds that only benefit private industries and are not functions of state and local government. We continue to support Congressional efforts to restrict small-issue, conduit industrial development bonds.[8]

Our Association has two principal concerns about the proliferation of small-issue IDBs. First, small-issue IDBs are occupying and increasing share of the tax-exempt bond market. The 1982 level is estimated at approximately $13.7 billion, or 16.1 percent of the market. Second, the universal availablity of small-issue IDBs in practically every state and community does not give any area an advantage in an economic development sense and may, in fact, promote the flight of downtown businesses away from our urban areas.

The MFOA has carefully studied the market for tax-exempt bonds and through this research, we have expressed legitimate concerns about its capacity to absorb, without cost, so-called conduit bonds. Small-issue IDBs must be examined along with all other conduit IDBs in order to fully understand their cumulative effect on the municipal bond market.

Of major concern to state and local governments is the extent to which small-issue and other IDBs are crowding out the market for conventional state and local debt issues, absorbing capital that would normally go to the financing of traditional governmental activity and driving up the costs of borrowing for all tax-exempt issuers. Research over the years has documented that the laws of supply and demand hold true in the tax-exempt market: the greater the demand for funds in relationship to the supply of savings at any given time, the higher will be the interest rates in the tax-exempt market.

Quantifying the impacts of increased supply of tax-exempt securities on the availability and cost of credit is difficult. Research findings indicate that the rapid growth and large volumes of credit demands do exert upward pressure on rates of interest and difficulties for traditional governmental borrowers that must compete for credit with new claimants. At current market levels, it is estimated that an increase of $1 billion in tax-exempt securities can be expected to generate interest rates that are 3 to 5 basis points higher for the overall market than otherwise would be the case.[9] For small debt issues that depend on support from local markets (and where there may be a high degree of substitution by investors between the traditional debt and that being sold for nontraditional purposes) the impact of increased volume on interest rates and credit availability can be much greater. For example, small issuers in states where there is a large amount of IDB financing would see their borrowing costs going up by a larger factor than would be true elsewhere in the market as a whole because of competition for local investment funds.[10]

Commercial bank purchases of industrial revenue bonds is not a healthy sign, in the long term, for the traditional municipal bond market. A CBO study estimates that 70 to 80 percent of small-issue sales are private placements.[11] Since most small-issue IDBs are privately placed with banks, there are limited opportunities for the banks to sell these tax-exempt securities. Banks may be filling their portfolios with tax-exempt IDBs and, therefore, lessening their ability to purchase tax-exempt bonds for schools, sewers, and street projects. With commercial banks maintaining their role as the single-largest holders of tax-exempt bonds any shift in their demand for general obligation (or tax-supported bonds for governmental purposes) is a disturbing sign for state and local governments. If tax-exempt IDBs continue to play a major role in providing capital financing for business and industry, then the traditional municipal bond market is headed for troubled waters.

Many proponents of IDBs claim they are an important economic development tool. They will tell you of the many jobs created through their use and of the firms that would not be able to build new facilities or expand existing facilities without this subsidy. The evidence simply does not support these claims. The universal availability of small-issue IDBs does not currently provide any individual community with a competitive advantage. One of the recent studies on this subject, by Margaret E. Dewer examined how effective IDBs are in influencing a corporation's local and expansion decision. According to Dewer:

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[8] "Conduit bonds" refer to industrial development bonds for which the issuing local government has no financial involvement with its own resources and also has no functional involvement in that the facility financed is one which it could not itself operate as its own public facility.

[9] For a review of recent studies regarding the interest rate effects of incremental supplies of tax-exempt bonds, see Ronald Forbes, et. al., "An Analysis of Tax-Exempt Mortgage Revenue Bonds," Municipal Study Group, State University of New York at Albany (May 1979), Appendix III.

[10] For an analysis of the local market impacts of increased offerings, see Hendershott, Patric and David Kidwell. "The Impact of Relative Security Supplies: A Test with Data from a Regional Tax-exempt Bond Market." Journal of Money, Credit and Banking. February 1978.

[11] CBO, Small Issue Industrial Revenue Bonds, p. 15.

* * * the importance of the interest rate subsidy and other advantages of using the bonds is not likely to outweigh the importance of location criteria such as the cost of shipping products or the cost of acquiring suitable land. If other location characteristics dominate the decisions, the bonds probably have virtually no effect on location and expansion choices. In that case, the major result of bond programs is to reward firms for behaving as they would without the programs.[12]

The lack of data on the use of IDBs has hampered the debate surrounding the utility and desirability of IDBs. A recent study of the use in IDB financing in the five states (Illinois, Indiana, Iowa, Michigan and Wisconsin) in the Seventh Federal Reserve District (Chicago) sheds some light on this method of channeling funds raised in the tax-exempt market into private endeavors but, again, the data are incomplete.[13]

The dramatic growth in the use of IDBs in the five states is attributed to the high cost of conventional business financing and attempts on the part of states and municipalities to attract or retain business. Although there is widespread use and diversity within the Seventh District, IDBs are used primarily by municipalities located within major metropolitan areas—except in Iowa where their use is centered in rural communities. The exception is explained by Iowa's predominantly rural makeup.

The MFOA has a longstanding policy supporting federal restrictions on small-issue IDBs with one exception carved out. The Association believes that small-issue IDBs could be used as an effective economic development tool if they are restricted to areas of serious economic deprivation. Instead of providing a subsidy so that firms can flee our downtown areas, we ought to be encouraging economic development in areas of serious economic deprivation.

Many of the state and local officials who are members of our Association have tried to restrict small-issue IDBs at the state and local level of government, but have come to the conclusion that it is extemely difficult, if not impossible, for any state or, for that matter, local government to ban or severely restrict IDBs when neighboring communities and states continue to offer them. State legislatures which have attempted to pass IDB restrictions have not been able to overcome this argument. It is our belief that the current small-issue IDB climate leads to negative and unhealthy competition among the states and unless federal restrictions are adopted, the use of small-issue IDBs will continue unabated.

MORTGAGE REVENUE BONDS

The Municipal Finance Officers Association is also concerned with the effects of the growing volume of single-family Mortgage Revenue Bonds on the tax-exempt market. We recognize that the single-family Mortgage Revenue Bond Program has played an important role in providing home mortgage financing at a time when the cost and availability of financing caused severe problems in the housing market. However, we recognize the need to preserve the tax-exempt market in order to insure the continuation of the basic, public services enjoyed by the citizenry.

With this in mind, we recently adopted a new mortgage revenue bond policy which retains the same basic philosophy found in our earlier policies, but directly addresses the sunset provision now being debated in the Congress. We recommend that the total volume of such bonds be reduced by state and local governments and endorse the continuation of the single-family mortgage revenue bond program for only three more years subject to the following additional conditions:

1. The use of single-family Mortgage Revenue Bonds should relate to the adequacy of affordable mortgage money available and the level of housing starts.
2. The use of single-family Mortgage Revenue Bonds should be targeted to low- and moderate-income individuals and community development and/or urban revi-

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[12] Margaret E. Dewar, The Usefulness of Industrial Revenue Bond Programs for State Economic Development: Some Evidence from Massachusetts, Working Paper No. 63 (Boston: Joint Center for Urban Studies of the Massachusetts Institute of Technology and Harvard University, March 1980) pp. 1–2.

[13] David R. Allardice, "Small-Issue Industrial Revenue Bonds in the Seventh Federal Reserve District," Economic Perspectives (Chicago: Federal Reserve Bank of Chicago, Winter 1982) pp. 12–22.

talization projects, and restricted to the area median price of housing. Limitations on these projects should be general in nature allowing flexibility for state and local governments designing programs which best meet their needs.

During the three year extension of the program, we urge the Congress and the Administration to study alternative methods to assist and support the housing market for low- and moderate-income homebuyers so states and localities will not have to consume large portions of the tax-exempt market for housing purposes. Again, our concern is with the vitality of the market on which states and localities must rely for reasonably priced capital financing.

NATIONAL ASSOCIATION OF INDUSTRIAL AND OFFICE PARKS,
Arlington, Va., June 21, 1983.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means,
Washington, D.C.

DEAR CHAIRMAN ROSTENKOWSKI: In response to the recent hearing held by the Committee on Ways and Means regarding the trends in municipal financing and the use of tax-exempt bonds to finance private activities, the National Association of Industrial and Office Parks (NAIOP) has submitted the attached statement for inclusion in the hearings record.

NAIOP represents more than 2,500 professionals involved in master-planning, designing, financing, constructing, and managing industrial and office park properties worth more than $66 billion in the United States. Of our 2,500 members, nearly 1,500 are professional developers who have an ownership interest in these parks. The remaining NAIOP members are executives who support the development industry in areas such as banking, brokerage and construction services. NAIOP members develop the structures that house this nation's established and emerging businesses.

As developers we are vitally interested in the availability of long-term financing and capital investment incentives. The availability of Industrial Development Bond financing has encouraged many small and medium-sized businesses to expand, where normal financial markets have made such expansion prohibitive.

The attached remarks by James C. Stuebner, President, Northland Development Company of Minneapolis Inc., on behalf of NAIOP are representative of our views when he says, "It takes approximately two years or more to plan, design, construct and finance new office, plant or warehouse buildings. It was just nine months ago that the Committee adopted the new ground rules on the use of IDBs. To change these rules now while buildings are underway, priced under contract at IDB financing rates, would cause financial disaster for many of us and our customers because there is no available substitute . . . Congress runs the serious risk of choking growth in new and expanding companies if it adopts the restrictions contained in HR 1635."

I respectfully invite your comments on the attached statement and look forward to hearing your views on the future of tax-exempt industrial development bond usage.

Sincerely,

WILLIAM A. MITCHELL, Jr.,
President, NAIOP.

Attachment.

STATEMENT OF JAMES C. STUEBNER ON BEHALF OF THE NATIONAL ASSOCIATION OF INDUSTRIAL & OFFICE PARKS

Mr. Chairman, Members of the Committee, I appreciate the opportunity to provide a written statement for the Committee on Ways and Means record on the importance of the continued availability of industrial development bonds to businesses in this country. I will also address some specific comments to H.R. 1635, the legislation that proposes that Congress adopt even harsher restrictions on the use of IDBs before the provisions that become law in the Tax Equiity and Fiscal Responsibility Act have fully demonstrated their effectiveness.

I am James C. Stuebner, President of Northland Development Company of Minneapolis, Inc., and Corporate General Partner of Northland Park, a 375-acre master-planned business park located in Minneapolis, Minnesota, where we have provided homes for 143 businesses and created more than 4,000 jobs. For several years I have worked actively with the Department of Economic Development of the State of Minnesota and other interested organizations to stimulate growth and provide new jobs in our state.

I am testifying on behalf of myself, my customer businesses and the National Association of Industrial and Office Parks (NAIOP). NAIOP is a membership organization of 2,500 professionals involved in master-planning, designing, financing, constructing, and managing industrial and office park properties worth more than $66 billion in the United States. Of our 2,500 members, nearly 1,500 are professional developers who have an overship interest in an office park or building. The remaining NAIOP members are executives who support the development industry in areas such as banking, brokerage and construction services.

Mr. Chairman, it takes approximately two years or more to plan, design, construct and finance new office, plant or warehouse buildings. It was just nine months ago that this committee adopted the new ground rules on the use of IDBs. To change these rules now while buildings are underway, priced under contract to lease or sell at IDB financing rates, would cause financial disaster for many of us and our customers because there is no available substitute.

I must admit to a sense of frustration about the IDB portion of these hearings. The conference report on TEFRA imposed the broadest range of restictions ever enacted on the use of industrial development bonds. Yet the press release announcing these hearings was written as if few changes were made last year or that those changes will have little or no effect on IDB volume or use. The release acknowledges that there may be legitimate uses of IDBs, but it goes on to say, "these either need to be identified more clearly in the Internal Revenue Code, or State and local governments need to issue such bonds under effective volume limits."

With all due respect, I believe this reflects a preconceived opinion that the sweeping changes in TEFRA have not affected the type or volume of projects that will be funded in the future. That view is not consistent with what we see happening.

After nearly two quarters of operating under the TEFRA IDB rules we believe that IDB volume will decline by at least 38 percent in the States of Minnesota. This estimate is based upon bonds approved for use so far this year with the projects that were funded last year. This drop in volume can be attributed to three factors, and two stem directly from the provisions of TEFRA.

First, the new procedures for approving IDBs take considerably more time and act as a screening process for projects. We already are seeing evidence that holding public hearings and requiring elected officials to approve IDBs will improve the IDB process and assert greater local government control over and responsibility for the decision to provide financing.

Moreover, IDB volume will drop because TEFRA bars financing for a long list of specific recreational and entertainment facilities; it further limits or eliminates financing for most other recreational, food service or automobile retail facilities; it requires all IDB-financed facilities to use only straight-line depreciation; and it prohibits the use of IDBs for franchises and multi-state projects of one company.

The second factor contributing to the drop in volume is the shrinking market for investors who purchase IDBs. TEFRA imposed a new surtax on bank carrying charges for tax exempt securities. As a result our local banks are buying fewer and fewer bonds even though in previous years they had been major investors.

Finally, despite the current talk about the recovery, it has not reached out to our market. Long-term mortgage capital still is not available at a feasible price. While interest rates have dropped from the prohibitive levels of only a few months ago, they still are hanging above the point where developers feel confident that they can proceed to build again on a profitable basis. There is no fixed-rate long-term financing available because the markets are not yet convinced that Congress and the President will jointly be able to bring the level of federal borrowing under control.

Let me specifically address the provisions of H.R. 1635 and the harsh effects I believe four of its major provisions would have on many new and expanding small and medium sized companies. I would point out that Congress considered and rejected each of these provisions only nine months ago.

The first would lengthen recovery periods for IDB-financed property from those provided in ERTA to much longer periods, including 25 years for structures. This was rejected last year because the IDB community demonstrated that given a choice between using IDBs and taking the longer recovery periods, the IDB would not be used, so the provision is designed to eliminate, not limit use.

Longer recovery periods are a disincentive to capital investment, building of new plants and equipment and the creation of new jobs. In one respect the longer period would be highly punitive because it would force recovery over 25 years for a total building while before 1981 the owner could have used component depreciation for different parts of the building bringing the overall recovery period down to an average of 15 to 17 years. It is disturbing that this would be proposed at a time when a number of economists are pointing out that ERTA has placed structures at a disadvantage relative to the recovery periods for other property and equipment. Furthermore, the rate at which a building is depreciated has no relationship to how it is financed and these two concepts should not be linked in our discussion of the merits of IDBs.

The second and third provisions would impose arbitrary limits of $20 million on the capital expenditures a company would be allowed three years prior to obtaining an IDB and $20 million on the amount of IDBs it could have outstanding. These limits appear to assume that there is a large number of major companies building facilities around the country with IDBs. I do not believe the facts will support that assumption, and the limits Congress imposed last year on franchises and composite issues makes it even more unlikely. However, the proposals do threaten an important source of financing for many job-creating high-technology companies.

For example, in Northland Park we have one new high-tech company which started only a year ago and has grown to $20 million in annual sales. That company, still in its infancy, is planning to put facilities around the country and in many cases it will seek IDB financing. Existing market rates would make that expansion impossible, but IDB financing can make it a reality.

Another company in our park is only five years old and is beginning its first major expansion. That expansion, which will help create 300 new jobs, would not occur at 12 to 15 percent financing which a younger company often is forced to pay. Thus, without the lower rate IDB financing the expansion would not go forward.

In both of these cases, the companies seeking IDB financing would be barred by the provisions of H.R. 1635, and yet anyone who saw their operations would characterize them as small to medium-sized companies, the source of 85 percent of the new jobs created each year in the United States.

In Northland, as in many industrial and office parks around the country we often see companies like these that are unable to raise the capital for a new building or building expansion. In those cases, the developer of the park or an independent office building developer is afforded the opportunity to build these facilities with IDB financing and lease it to the new and growing company. More and more NAIOP members see themselves as providing the workplaces for the future as our economy becomes more information and service oriented. The arbitrary limits proposed in H.R. 1635 would bar many developers from providing this opportunity through the use of IDB financing.

The last provision in the bill that raises serious questions is the bar against using IDB financing to purchase land. I understand that this may be aimed at a different problem, but the development of an industrial or office building site involves the payment of a significant portion of the total cost for land acquisition. Moreover, the choice of the site often is the most critical decision in the potential success of an industrial and office park. Again, it seems somewhat arbitrary to allow financing for the structure but not for the land on which it is located. Land is an integral part of the cost of any industrial or office facility. For example, four companies located in Northland Park obtained IDB financing for the purchase of land on which they have built office buildings.

Finally, Mr. Chairman, I would like to address the major assumptions which appear to be driving the efforts to further restrict the use of IDBs—that there is an adverse conclusion to be drawn from the volume of IDBs issued either in potential revenue loss or in the impact on other tax-exempt issues. I believe both of those assumptions are in error.

The Treasury Department continues to estimate IDB revenue loss based upon the projected taxes they think could be collected on IDB interest but their estimates do not reflect the feedback into the economy from IDB projects in terms of jobs created, materials and equipment purchased, and the local, state and federal taxes generated from those activities. This is a point that has been made repeatedly by an important authority on the subject—former Treasury Under Secretary, Dr. Norman B. Ture. With respect to the positive "ripple" effect that IDB financed projects can have on a local economy, I would offer my experience that over a 10 year period a $1 million office building can generate as much as $18.8 million in new payroll expenses and taxes. (See Appendix A)

Second, economists also have raised serious questions about the method Treasury uses to estimate the revenue loss. They make the assumption that there would be a nearly direct shift by investors into taxable securities if they no longer purchase IDBs. Dr. Roger Kormendi, a municipal finance expert at the University of Chicago, has challenged that assumption using Federal Reserve Board data to demonstrate that investors seeking non-taxable investments first will look to other similar investments or partially sheltered investments before investing in a fully taxable security.

Third, the Treasury projections do not reflect the fact that the owner/developer of an office building may deduct the interest he pays on conventional loans. These reductions will reduce the net amount of taxes actually paid over the term of the loan by the holders of the notes. Thus, while the note-holder must pay taxes on the interest that would be earned, the amount of the interest is being deducted as a business expense by the developer/owner.

Fourth, it would appear that overall economic factors and other changes in the tax code adopted by Congress have had a far greater affect on municipal bond prices than the volume of IDBs. Even so, some opponents of IDBs have argued that as bond volume increases, municipal rates increase relatively more than taxable rates, thus reducing the difference between municipal and taxable bond rates. Dr. Kormendi and other experts have questioned whether in reality the volume of IDBs significantly pushes up all tax-exempt bond rates. If volume had been the major factor in determining tax-exempt rates, the near doubling of bond volume relative to the economy from 1959 to 1982 would have been accompanied by a narrowing of the spread, not the 11 percentage point widening which actually occured, dropping tax-exempt rates from 90 percent to 79 percent of taxable bond rates. In fact, a review of bond rates over the past 25 years indicates that volume appears to have had very little to do with the spread.

Mr. Chairman, I would conclude by asking that you and this Committee seriously reassess the effect which the adoption of further restrictions would have on new and growing companies and the jobs they produce in this country. My experience in Minnesota is not an isolated one.

Members of our association from around the country have repeatedly told us of the important role IDBs have played in the startup and expansion of new businesses. The National Association of Industrial and Office Parks is strongly opposed to the enactment of any further restrictions on IDBs. TEFRA imposed the most severe restrictions ever applied to the use of IDBs. Moreover, those restrictions have not been in effect long enough to assess the effect they will have on IDB use. We do not believe that H.R. 1635 will generate any significant new tax revenues, yet H.R. 1635 would cut off the only affordable or available source of financing for new economic growth.

Developers of industrial and office facilities have, in effect, become an important source of venture capital for new and expanding companies. By providing the capital to construct office and manufacturing space, we are able to help meet the startup and expansion needs of these companies. We simply cannot do this job if the government is going to change the rules every year. What we need to get American business going again on a world-wide competitive basis is the confidence to be able to make long-term plans with stable governmental economic policies. IDBs historically have provided a critical source of financing to companies at times when conventional financing has been unaffordable or unavailability.

We are just now emerging from a period in which that important financing role has been demonstrated repeatedly by companies that would have delayed or abandoned job creating projects if they had been unable to borrow needed capital. Congress runs the serious risk of choking growth in new and expanding companies if it adopts the restrictions contained in H.R. 1635.

APPENDIX A.—ECONOMIC IMPACT $1,000,000 COMMERCIAL OFFICE DEVELOPMENT

I. $1,000,000 COMMERCIAL OFFICE BUILDING

16,000 sq. ft. building area at $62.60/sq. ft.
200 sq. ft./person = 80 jobs.
$20,000/person average payroll and benefits × 80 = $1,600,000.
Increase in Minnesota income tax at 7 percent = $112,000.
Increase in Federal income tax at 35 percent = $400,000.

II. $1,000,000 CONSTRUCTION VALUE

Assume 30 percent direct labor = $300,000.
Minnesota income tax at 7 percent = $21,000.
Federal income tax at 35 percent $75,000.
Value of materials purchased = $300,000.
Value of services purchased:

Architects, engineers, lawyers = $150,000 × 35 percent = $52,000 in Federal tax dollars.

Interest paid to banks and financial interest = $150,000 (assuming a 15 percent interest rate).

Profit available for savings or spent = \$100,000 × 52 percent = \$52,000 in Federal income tax dollars (labor, materials, services).

Property taxes paid = \$1,000,000 × 43 percent (assessment rate).

Assessed market value \$430,000.

Property taxes paid to state, county and local government, assuming 100 mill rate = \$43,000.

Total first year economic impact per 1 million dollar office space added to economy = \$3,355,500.

Annual economic impact per: payroll = \$1,600,000; state taxes = \$176,000; federal taxes = \$400,000 = \$2,176,000.

Total ten year impact Minnesota and Federal economy per 1 million dollar office space = \$22,939,500.

Assuming 80 percent financed by industrial revenue bonds at 10 percent interest. Annual interest = \$80,000.

If taxable at 30 percent = \$24,000 per year = \$240,000 over ten years maximum loss to Treasury.

STATEMENT OF JOHN H. FITCH, JR., VICE PRESIDENT, GOVERNMENT RELATIONS, NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS

Mr. Chairman, Members of the Committee, my name is John H. Fitch, Jr., Vice President for Government Relations for the National Association of Wholesaler-Distributors (NAW). I appreciate the opportunity to submit for the record the views of the wholesale distribution industry on H.R. 1635, the Industrial Development Bond Limitation Act.

NAW is a federation of 120 national wholesaler-distributor associations listed in Appendix A. These organizations have a collective membership of approximately 45,000 member firms with 150,000 places of business. They are located throughout the fifty states, essentially in proportion to the population. Moreover, NAW has an individual firm membership of 7,000.

Our industry is characterized preponderantly by small- to medium-sized firms. Thus, the typical wholesaler-distributor has an annual gross sales volume of \$5 to \$7 million and employs 40 individuals. Nonetheless, when viewed in th aggregate, merchant wholesaler-distributors constitute a vital sector of our economy, as evidenced by the Commerce Department's estimate that they would be responsible for more than one trillion dollars of economic activity during 1983. Further information on the structure and significance of the wholesale distribution industry to the nation's economy is contained in Appendix B.

Since their inception, industrial development bonds have been a vital source of low cost capital for wholesaler-distributors in the growth and expansion of their businesses.

Essentially dependent on commerical bank financing for inventory purchases, accounts receivable financing and capital construction, wholesaler-distributors are particulary subject to the ravages of inflation and high interest rates.

As closely-held, family-owned corporations, few credit options are available to them from outside the traditional methods of capital formation and financing.

One of these options is the industrial development bond (IDB).

IDBs serve one very critical function for interest rate sensitive wholesaler-distributors, it provides low cost financing for construction and modernization their one major capital asset . . . their warehouse.

In order to remain competitive and to meet the dramatic marketplace changes that are occuring (see attached "Future Trends in Wholesale Distribution" brochure), wholesaler-distributors must not only move to and service the changing population centers but also must update their plant and equipment as well.

Financially conservative and traditionally low leverage businesses, wholesaler-distributors view IDBs as serving a valid public purpose and should be retained.

Small business has very few capital formation alternatives as it is, to repeal or practically deny IDBs would place a serious and in many cases insurmountable (and unnecessary) road block in their ability to survive; much less grow and expand.

In that regard, I've attached an illustration from one of our members, Townley Hardware, of how important IDBs are to our industry.

NAW is not insensitive to the arguments put forth by Rep. Pickle and others that IDBs have been used by those in the private sector who are otherwise able to finance the construction of commercial buildings; however, we believe the significant changes made in the IDB area by TEFRA adequately address the problem.

However, the abolition of the small issue IDBs in our judgment went too far. We believe that they should be allowed to continue and that the sunset date of 1986 should be repealed.

There has been no valid evidence put forth in our minds which justifies repealing small issue IDBs.

It only adds insult to injury for wholesaler-distributors and other small businesses.

Having said that, it would be our opinion that H.R. 1635 is unnecessary. TEFRA removed the perceived abuse problem and otherwise tightened the IDB eligibility standards and procedures for obtaining a bond.

However, to the extent that H.R. 1635 does not repeal IDBs, we would not oppose it.

In fact, if it contained a provision to repeal the small issue sunset date NAW would actually support it.

While elimination of the use of ACRS for IDB financed structures is reasonable in our judgment, the stretching out of the dependable lives for IDB financed warehouses for 15 years to 25 years causes us some concern. While ACRS in the main did little for wholesaler-distributors, its most valuable provision was the reduction of warehouse depreciation to 15 years. That feature alone gave wholesaler-distributors a realistic return on investment in a capital asset that greatly assists on modernization, growth and expansion which, in turn, increases efficiency and competition and reduces cost.

Special interest aside, NAW believes that IDBs are an excellent and relatively low cost (to the federal government) mechanism for economic growth and development and job creation. Moreover, it gives wholesaler-distributors and other small businesses the affordable opportunity to increase their domestic as well as international competitiveness and meet the needs of a rapidly changing marketplace. In our view IDB have a supportable policy purpose.

Finally, Mr. Chairman, I would like to state NAW's strong opposition to an alternative to the current IDB concept which has been proposed . . . the state volume limitation.

We believe this approach will in the long run "squeeze out" small business utilization of IDBs forcing an unnecessary bias away from private sector utilization. That would in our judgement destroy their effectiveness and cause economic stagnation in the population centers.

As stated above, NAW believes the current system for IDB issuance as modified by TEFRA and with the changes we've suggested here more than adequately serve the public as well as the private sector needs.

Thank you, Mr. Chairman for the opportunity to present our views on this very important issue.

NATIONAL WHOLESALER-DISTRIBUTOR ORGANIZATIONS AFFILIATED WITH THE NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS

Air-conditioning & Refrigeration Wholesalers.
American Dental Trade Association.
American Jewelry Distributors Association.
American Machine Tool Distributors Association.
American Supply Association.
American Traffic Services Association.
American Veterinary Distributors Association.
Amusement & Vending Machine Distributors Association.
Appliance Parts Distributors Association, Inc.
Associated Equipment Distributors.
Associated Wire Rope Fabricators.
Association of Footwear Distributors.
Association of Steel Distributors.
Automotive Service Industry Association.
Aviation Distributors & Manufacturers Association.
Bearing Specialists Association.
Beauty & Barber Supply Institute, Inc.
Bicycle Wholesale Distributors Association, Inc.
Biscuit & Cracker Distributors Association.
Ceramic Tile Distributors Association.
Ceramics Distributors of America.
Coated Abrasives Fabricators Association.
Copper & Brass Servicenter Association.

Council for Periodical Distributors Association.
Council of Wholesale-Distributors American Institute of Kitchen Dealers.
Distributors Council, Inc.
Door & Hardware Institute.
Drug Wholesalers Association.
Electrical-Electronics Materials Distributors Assn.
Explosive Distributors Association, Inc.
Farm Equipment Wholesalers Association.
Flat Glass Marketing Association.
Fluid Power Distributors Association, Inc.
Food Industries Suppliers Association.
Foodservice Equipment Distributors Association.
General Merchandise Distributors Council.
Health Industry Distributors Association.
Hobby Industry Association of America.
Independent Medical Distributors Association.
Institutional & Service Textile Distributors Association, Inc.
International Ceramic Association.
Irrigation Association.
Machinery Dealers National Association.
Mass Merchandising Distributors Association.
Material Handling Equipment Distribution Association.
Monument Builders of North America-Wholesale Div.
Motorcycle Industry Council.
Music Distributors Association.
National-American Wholesale Grocers' Association.
National Appliance Parts Suppliers Association.
National Association of Aluminum Distributors.
National Association of Chemical Distributors.
National Association of Container Distributors.
National Association of Decorative Fabric Distributors.
National Association of Electrical Distributors.
National Association of Fire Equipment Distributors.
National Association of Floor Covering Distributors.
National Association of Manufacturing Opticians.
National Association of Marine Services, Inc.
National Association of Meat Purveyors.
National Association of Plastics Distributors.
National Association of Recording Merchandisers, Inc.
National Association of Service Merchandising.
National Association of Sporting Goods Wholesalers.
National Association of Textile & Apparel Distributors.
National Association of Tobacco Distributors.
National Association of Writing Instrument Distributors.
National Beer Wholesalers Association.
National Building Material Distributors Association.
National Business Forms Association.
National Candy Wholesalers Association.
National Commercial Refrigeration Sales Association.
National Electronic Distributors Association.
National Fastener Distributors Association.
National Food Distributors Association.
National Frozen Food Association.
National Grocers Association.
National Independent Bank Equipment Suppliers Association.
National Industrial Belting Association.
National Industrial Glove Distributors Association.
National Lawn & Garden Distributors Association.
National Locksmith Suppliers Association.
National Marine Distributors, Association.
National Paint Distributors, Inc.
National Paper Trade Association, Inc.
National Plastercraft Association.
National Sash & Door Jobbers Association.
National School Supply & Equipment Association.
National Solid Wastes Management Association.
National & Southern Industrial Distributors Associations.

National Spa and Pool Institute.
National Truck Equipment Association.
National Welding Supply Association.
National Wheel & Rim Association.
National Wholesale Druggists' Association.
National Wholesale Furniture Association.
National Wholesale Hardware Association.
Northamerican Heating & Airconditioning Wholesalers.
North American Wholesale Lumber Association, Inc.
Optical Laboratories Association.
Outdoor Power Equipment Distributors Association.
Pet Industry Distributors Association.
Petroleum Equipment Institute.
Power Transmission Distributors Association, Inc.
Safety Equipment Distributors Association, Inc.
Scaffold Industry Association.
Shoe Service Institute of America.
Specialty Tools & Fasteners Distributors Association.
Spring Service Association.
Steel Service Center Institute.
Textile Care Allied Trades Association.
Toy Wholesalers' Association of America.
United Pesticide Formulators & Distributors Association.
Wallcovering Distributors Association.
Warehouse Distributors Association for Leisure & Mobile Products.
Watch Materials & Jewelry Distributors Association.
Water and Sewer Distributors Association.
Wholesale Florists & Florist Suppliers of America.
Wholesale Stationers' Association, Inc.
Wine & Spirits Wholesalers of America, Inc.
Wood Heating Alliance.
Woodworking Machinery Distributors Association.

"This is the most
important piece
of research on our
industry I've seen in 35 years
of business. We are getting our
management team into it."

Wholesaler-Distributor
Phoenix, Arizona

DREF is the long-range research arm of the National Association of Wholesaler-Distributors

DREF'S LATEST REPORT,

Future Trends In Wholesale Distribution Reveals:

- **What our industry's primary and secondary sources of capital will be**
- **Which size firms will increase sales most . . . and least**
- **What services suppliers and customers will expect of wholesaler-distributors . . . and what services our industry will provide**
- **How task assignments will shift between inside and outside sales**
- **What transportation changes are coming for the industry**
- **How—to what extent—our industry will use electronic communications to improve efficiency**
- **How personnel—and personnel training requirements—will change**
- **What types of warehouse mechanization equipment will be most commonly used**

. . . and scores of other findings!

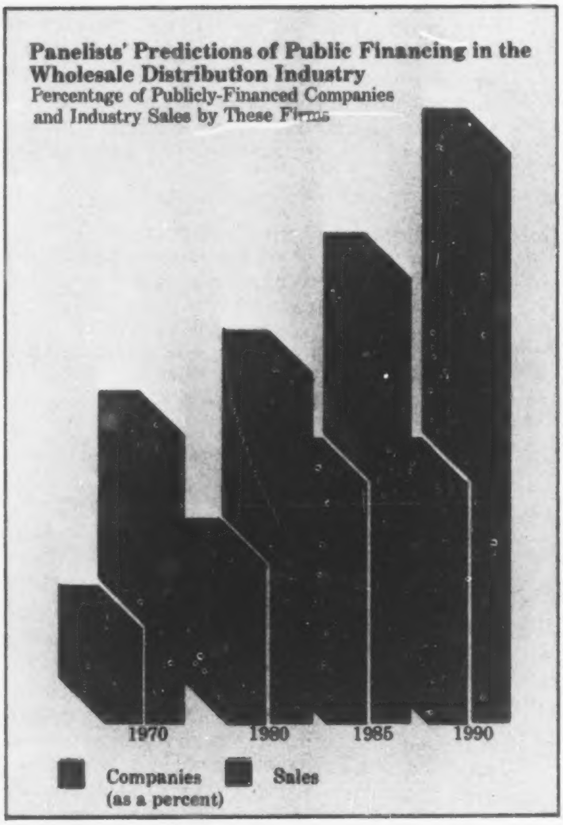
"Future Trends"
summary

FUTURE TRENDS IN WHOLESALE DISTRIBUTION

The National Association of Wholesaler-Distributors (NAW) and its research organization, the Distribution Research & Education Foundation (DREF), recently determined that future changes in the wholesale distribution industry—and the rate at which they are likely to occur—warranted an in-depth study of future trends in distribution.

The project, FUTURE TRENDS IN WHOLESALE DISTRIBUTION: A TIME OF OPPORTUNITY, was put together for DREF by Arthur Andersen & Co., the international consulting, auditing and tax organization. The project's objective: to

Panelists' Predictions of Public Financing in the Wholesale Distribution Industry
Percentage of Publicly-Financed Companies and Industry Sales by These Firms



Reprinted from FUTURE TRENDS report

point wholesale distribution company executives toward the most likely directions our industry is moving in the 1980's...and will move in the 1990's.

More than 250 wholesale distribution experts—drawn from wholesale distribution, manufacturing, academia, trade associations, the press and consulting professions, participated in the FUTURE TRENDS project. They responded to detailed questionnaires in four well-defined subject areas: the wholesale distribution marketplace; capital formation and retention; technology; and, human resources. From this data emerged their highly-qualified composite of our industry's future. Some of their predictions:

Marketplace Growth

- Total wholesale sales will grow 4.2% per year between 1981-85 and 4.9% per year between 1986-90, higher than the forecast GNP growth.
- Merchant wholesalers will increase their share of total sales to 58% in 1990.
- The major reasons for growth will be: productivity improvements in the wholesale distribution channel; economic influences on suppliers and customers; and increased value-added services provided by wholesaler-distributors.

Competitive Structure of the Marketplace

- Changes in the size of the individual companies will have a strategic impact on the competitive environment; medium-size companies will be in a particularly strong competitive position, combining financial advantages of size with the flexibility to respond quickly to marketplace changes.
- There will be an increased number of distribution groups.
- Foreign companies will increase U.S. sales and ownership dramatically by 1990.
- Publicly-financed companies will increase significantly (see chart, previous page).

W-D Functions

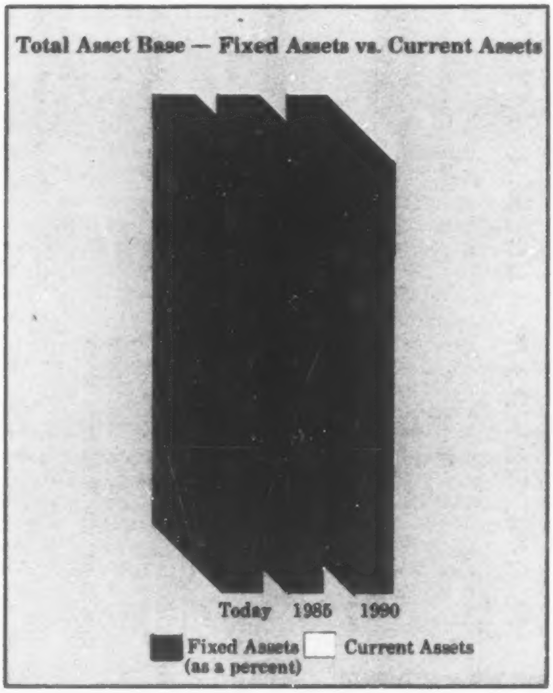
- Changes in wholesaler-distributors' functions will, in part, cause growth greater than the overall growth of the economy.
- Wholesalers will perform more value-added services, some of which were previously performed by suppliers or customers, including: inventory control for customers; educational seminars; market analysis; financial management services; packaging and final product conversion; labelling; and, technical sales support.
- By 1990, there will be as many inside as outside sales persons in the average firm. Inside sales personnel will

→

perform more of a selling role, as distinct from order-taking; the outside sales force will perform more of a promotional/marketing function.

Profitability

- Changes in wholesaler-distributors' functions will cause changes in wholesaler-distributors' profit, cost and asset base structures (see chart, below).
- Wholesalers will need substantial capital to finance expected growth, at the same time as they face increased competition from other industries for available capital. Two-thirds of the study participants felt that internal cash will continue as the most important source of capital, making steady productivity and profit improvement an imperative.
- Wholesalers will increasingly emphasize effective use of resources such as personnel, warehouse and delivery assets.



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☐ **check here if you'd like information on other NAW/DREF publications.**

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Wholesaler-Distributors
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1725 K Street, N.W.
Washington, D.C. 20006

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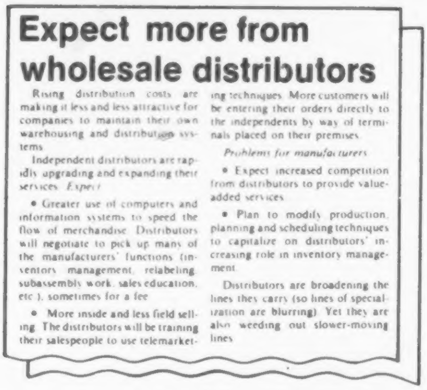
Media Reviews *FUTURE TRENDS IN WHOLESALE DISTRIBUTION*

Boardroom Reports...



Expect more from wholesale distributors

Rising distribution costs are making it less and less attractive for companies to maintain their own warehousing and distribution systems.

Independent distributors are rapidly upgrading and expanding their services. *Expect:*

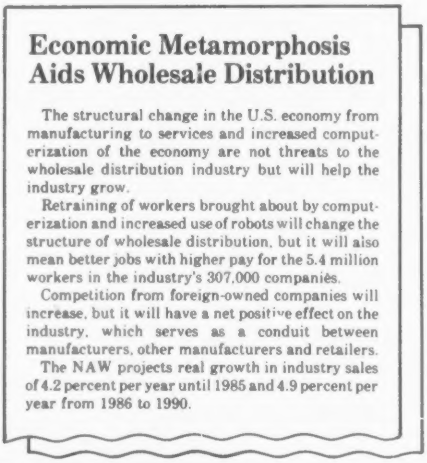
- Greater use of computers and information systems to speed the flow of merchandise. Distributors will negotiate to pick up many of the manufacturers' functions (inventory management, relabeling, subassembly work, sales education, etc.), sometimes for a fee.
- More inside and less field selling. The distributors will be training their salespeople to use telemarketing techniques. More customers will be entering their orders directly to the independents by way of terminals placed on their premises.

Problems for manufacturers:

- Expect increased competition from distributors to provide value-added services.
- Plan to modify production, planning and scheduling techniques to capitalize on distributors' increasing role in inventory management.

Distributors are broadening the lines they carry (so lines of specialization are blurring). Yet they are also weeding out slower-moving lines.

Journal of Commerce...



Economic Metamorphosis Aids Wholesale Distribution

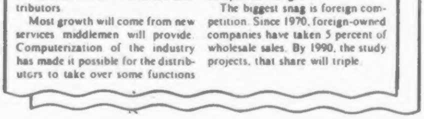
The structural change in the U.S. economy from manufacturing to services and increased computerization of the economy are not threats to the wholesale distribution industry but will help the industry grow.

Retraining of workers brought about by computerization and increased use of robots will change the structure of wholesale distribution, but it will also mean better jobs with higher pay for the 5.4 million workers in the industry's 307,000 companies.

Competition from foreign-owned companies will increase, but it will have a net positive effect on the industry, which serves as a conduit between manufacturers, other manufacturers and retailers.

The NAW projects real growth in industry sales of 4.2 percent per year until 1985 and 4.9 percent per year from 1986 to 1990.

USA Today...



Wholesaler-distributor is in a growth position

The middleman role is expanding. *Future Trends in Wholesale Distribution* says that in the next decade wholesale and distribution sales will grow by 4 percent a year.

By 1990, "suppliers and customers will shift responsibility for some services to the wholesaler-distributor," said James W. Norris of Arthur Anderson & Co., which orchestrated the study for the National Association of Wholesaler-Distributors.

Most growth will come from new services middlemen will provide. Computerization of the industry has made it possible for the distributors to take over some functions retailers and suppliers don't want: training seminars, financial and inventory management, and market research.

Wholesalers will expand the geographical areas in which they work. The study predicts the number of distribution companies will double in the next 10 years. The number of small wholesalers will shrink while the number of medium and large companies will grow.

The biggest snag is foreign competition. Since 1970, foreign-owned companies have taken 5 percent of wholesale sales. By 1990, the study projects, that share will triple.

Distribution Research & Education Foundation

National Association of Wholesaler-Distributors
1725 K Street, NW Suite 710
Washington, D.C. 20006
(202) 872-0885

U.S. WHOLESALE DISTRIBUTION INDUSTRY SUMMARY STATISTICS BY STATE [1]

	Establishment (number)	Sales (dollars in thousands)	Average sales dollars per establishment	Payroll (dollars in thousands)	Employees (number)
I. National: Wholesale trade	382,837	1,258,400,268	3,287,039	58,289,573	4,397,089
II. State:					
Alabama	5,713	14,185,813	2,483,076	705,379	63,548
Alaska	649	1,562,699	2,407,857	115,905	6,232
Arizona	3,587	8,091,848	2,255,882	470,913	39,139
Arkansas	3,665	6,769,264	1,847,002	361,955	34,023
California	36,704	128,628,351	3,504,478	6,334,251	448,808
Colorado	5,457	15,617,678	2,861,953	790,751	60,824
Connecticut	4,694	19,233,684	4,097,504	811,741	59,102
Delaware	770	5,155,611	6,695,599	192,376	12,441
District of Columbia	594	2,154,745	3,627,517	169,063	10,866
Florida	15,409	34,380,491	2,231,195	18,822,284	158,901
Georgia	10,085	35,213,332	3,491,654	1,462,358	118,161
Hawaii	1,569	2,571,489	1,638,935	177,556	14,695
Idaho	2,037	3,194,237	1,568,108	210,537	20,338
Illinois	21,237	97,080,216	4,574,021	4,207,197	280,312
Indiana	8,875	25,439,511	2,866,424	1,223,642	97,402
Iowa	7,646	20,078,789	2,626,051	825,097	68,559
Kansas	5,349	17,460,965	3,264,342	652,573	53,949
Kentucky	5,133	13,485,315	2,627,180	646,720	56,075
Louisiana	6,800	19,568,473	2,877,717	955,683	81,238
Maine	1,580	2,830,910	1,791,715	177,823	16,725
Maryland	5,019	16,900,800	3,367,364	902,244	67,121
Massachusetts	9,107	30,235,785	3,320,060	1,549,866	113,072
Michigan	12,527	45,151,519	3,591,435	2,108,920	141,484
Minnesota	8,625	29,092,203	3,373,009	1,283,969	94,320
Mississippi	3,592	6,980,066	1,943,225	380,486	36,158
Missouri	10,007	35,080,391	3,511,149	1,519,797	115,784
Montana	1,815	2,968,857	1,635,734	162,348	14,176
Nebraska	4,164	10,648,164	2,557,196	494,245	42,273
Nevada	995	1,747,881	1,756,664	126,617	9,467
New Hampshire	1,223	2,024,293	1,655,186	147,703	12,097
New Jersey	12,997	55,327,312	4,256,929	2,651,785	182,023
New Mexico	1,969	2,714,261	1,378,497	192,127	17,297
New York	38,149	65,380,274	4,335,114	6,115,472	410,502
North Carolina	9,571	27,513,222	2,874,644	1,263,867	107,777
North Dakota	2,126	3,889,871	1,829,667	195,510	16,981
Ohio	16,643	61,702,900	3,707,439	2,927,562	212,354
Oklahoma	5,488	13,420,256	2,445,382	638,877	53,447
Oregon	4,904	18,085,350	3,687,877	765,363	54,312
Pennsylvania	17,536	53,711,351	3,067,995	2,817,940	211,479
Rhode Island	1,480	3,075,704	2,078,178	206,420	16,803
South Carolina	4,112	8,265,612	2,010,120	461,821	41,859
South Dakota	1,897	3,401,448	1,793,067	162,051	15,433
Tennessee	7,406	29,277,435	3,953,205	1,127,124	92,501
Texas	26,370	87,681,954	3,325,065	3,853,446	309,616
Utah	2,301	5,361,938	2,330,264	327,991	26,561
Vermont	746	1,036,523	1,389,441	75,025	7,068
Virginia	6,254	19,088,402	3,052,191	955,166	79,315
Washington	7,091	19,852,195	2,799,633	1,084,836	76,615
West Virginia	2,372	4,492,662	1,894,040	299,671	25,317
Wisconsin	7,874	19,648,057	2,495,308	1,111,980	86,408
Wyoming	879	1,940,161	2,207,237	75,540	6,131

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[1] Compiled by the National Association of Wholesaler-Distributors from 1977 U.S. Census of Wholesale Trade.

For further information on the wholesale distribution industry and the National Association of Wholesaler-Distributors, write: NAW, 1725 K. Street, N.W., Washington, D.C. 20006; or call: 202/872-0885.

TOWNLEY HARDWARE CO.,
November 18, 1981.

Mr. JOHN FITCH,
National Association Wholesalers-Distributors, Washington, D.C.

DEAR JOHN: You asked for a brief statement from us regarding our financial perspective on Industrial Revenue Bonds. Attached is a report to me by our Robert C. Butler that expresses our position most succinctly and candidly.

We are receiving answers to my original letter from all the Kansas congressional elected officials. In due course I will send copies to you.

Sincerely,

HOYT H. THOMPSON,
President.

Attachment.

NOVEMBER 12, 1981.

To: Hoyt Thompson.
Re new office and warehouse.

Industrial Revenue Bond Financing was absolutely critical to this project. When we first began feasibility studies aproximately 3 years ago, conventional financing was available at rates below 10% for a period of 20 years. By the time we were actually ready to secure financing, rates were in the area of 20% and very little fixed rate money was available. This project represents a very large undertaking and there is no way it could have been done with conventional financing. We simply could not meet the debt service requirements and it would be extremely hazardous to expose ourselves to possible increases in debt service associated with variable rate financing. The wholesale hardware industry generates about $.02 profit for every $1.00 of sales. In our case, we have found that most of this is required to finance increases in inventories and receivables brought about by sales growth. This does not leave large amounts remaining for capital expansion.

Through the use of Industrial Revenue Bonds we have been able to obtain financing at reasonable rates, thereby producing a debt service schedule that we can live with. The rates are also fixed for a term of 20 years which eliminates uncertainties as to future cash requirements. Our other lendors also play an important role in this project. With Industrial Revenue Bond Financing we have a viable package; without it we have one that just won't fly.

ROBERT C. BUTLER,
Vice President-Finance.

STATEMENT OF HON. WILLIAM F. WINTER, GOVERNOR OF MISSISSIPPI, ON BEHALF OF THE NATIONAL GOVERNORS' ASSOCIATION

Mr. Chairman and distinguished Members of Congress, I appreciate the opportunity to submit written testimony on behalf of the National Governors' Association (NGA) and its Committee on Community and Economic Development. I had arranged to appear before you on June 14, 1983, but when the Committee hearing dates were changed my schedule did not permit me to attend. The two issues that I will address are the continuation of the mortgage revenue bond and industrial revenue bond programs.

My testimony can be summarized as follows:

SUMMARY

NGA supports H.R. 1176, the Housing Finance Opportunity Act of 1983, and opposes Sections 2 and 4 of H.R. 1635, the Industrial Development Bond Limitation Act of 1983.

Mortgage revenue bonds (MRBs) are an effective and efficient vehicle for assisting our citizens purchase their first homes. Assistance is needed because the cost of housing is rising while the income of first time purchasers is not rising at the same rate. The demographics and economics suggest that the situation will worsen. Mortgage revenue bonds have been a significant tool to address housing affordability problems and at the same time play an important role in State economic development strategies. MRBs provide significant benefits at modest cost to the federal government. NGA supports the elimination of the MRB sunset and opposes the imposition of any further restrictions on the program. When H.R. 2673, the bill repealing the withholding of interest and dividends, reaches Conference, NGA asks that you retain the substance of H.R. 1176 which has been added to the bill by the Senate.

NGA supports industrial revenue bonds as a flexible, essential, efficient State economic development tool. Numerous restrictions were imposed on the industrial revenue bond program in 1982, but many of them did not become effective until January 1, 1983. Abuses and dollar losses to the Treasury were addressed. Preliminary indications are that industrial revenue bond issuance is dramatically down. According to the Public Securities Association, small issue industrial development bond volume was down 53 percent in the first quarter over the same period last yer. Section 2 of H.R. 1635, which NGA opposes, would not just reduce federal revenue losses but eliminate the use of the industrial revenue bond program. Section 4 is also problematic. Section 4 is unnecessary because small issue industrial development bonds are already targeted to small business. it also establishes an unwieldy limitation which will probably be counter-productive to job creation and economic recovery.

The bond market is capable of absorbing a significant additional volume of tax exempt securities without increasing the cost of financing of States and localities. Recent increases in municipal bond costs have been due primarily to the absence of bank and insurance company purchases, federal borrowing, reduced personal and corporate income tax rates and competing tax shelters.

There is no need to further restrict industrial revenue bonds. If Congress chooses to act now, it should eliminate the ACRS trade-off for industrial revenue bonds and eliminate the sunset for small issue industrial development bonds.

NGA AND STATE SUPPORT FOR MORTGAGE REVENUE BONDS

NGA supports H.R. 1176, the Housing Finance Opportunity Act of 1983, which eliminates the December 31, 1983 sunset of the Mortgage Revenue Bond (MRB) Program. The National Governors' Association is not alone. It joins 318 House cosponsors, 77 Senators and virtually ever other public interest group, in favor of preserving the program.

NGA is firmly committed to maintaining the ability of the States to provide housing finance assistance, especially for first-time homebuyers. At NGA's winter meeting here in Washington, D.C. this past March, the Governors unanimously adopted a policy position in support of the elimination of the sunset date of December 31, 1983, and the provision of mortgage financing for first-time homebuyers. NGA's policy reads:

"The Mortgage Revenue Bond Program is an important vehicle for the financing of home ownership and rental housing in areas where the private sector is not adquately meeting the demand. The Congress passed the Mortgage Subsidy Bond Tax Act of 1980 in order to place significant restrictions on an existing program, and thereby meet perceived abuses and reduce the level of use. There is no need to further restrict the program. Congress should avoid or remove unnecessary restrictions on States' use of mortgage revenue bonds. Congress must eliminate the provision that "sunsets" the Mortgage Revenue Bond Program on December 31, 1983."

NGA support reflects the support for the program in the individual States. Forty-nine States have State-wide housing finance agencies empowered to provide home-ownership financing.

LACK OF AFFORDABLE HOUSING

The MRB Program addresses significant problems.

Housing prices rose faster than incomes from 1970 to 1980. In 1970 the median family income was approximately $10,000 while the median new single family home cost $23,000. In 1980, the median family income was $23,500, but the median new single family home price was $70,000. In some growth areas such as the Sunbelt, the Mountain States and the West Coast, median housing prices increased from 2½ to 6 times median income between 1970 and 1980. In the same period mortgage interest rates doubled from 8 percent to 16 percent. We have reached a point where only 15 percent of first-time homebuyers can afford to purchase the median priced new house—a sharp drop from the 50 percent who could do so 10 years ago. Today, housing prices and interest rates are so high, even in light of the most recent interest rate decreases, that a majority (60 percent) of existing homeowners could not afford to purchase their present homes without the benefit of their accrued equity. The building industry is depressed, and new households have little hope for home ownershop.

Housing demand will increase and the cost of financing will remain high. The 1950's "baby boom" is projected to result in 9 million new households in the next 5 years, a 15-percent increase over the high level of household formations that occurred from 1975 to 1980. The cost of financing a home is expected to remain high in the 1980's. During the late 1970's, the "real" rate of mortgage interest was near zero—the mortgage interest levels were at or below the rate of general inflation. Now the "real" interest rate is clearly positive—mortgate interest levels are five to six points above the general inflation rate, and lending institutions are not likely to give housing the favorable treatment it received in the 1970's.

RESPONSE TO LACK OF AFFORDABILITY

In the early 1970's homebuyers where able to make some financial adjustments to meet higher prices and interest rates. They increased their incomes by increasing the number of household members working. Between 1970 and 1980, households with two working members rose from 40 to 60 percent of total households. Moreover, first-time homebuyers began to spend a larger share of their gross income on housing—the proportion went from 25 percent to 30 percent. But such future adjustments will be difficult. People cannot do much more to increase their spending for housing without cutting back substantially on other expenditures such as food, clothing and education.

As housing has clearly become unaffordable to the majority of the Nation's population, tax-exempt revenue bonds represent one solution. In 1982, 10 percent of all new single-family housing was financed by MRB's, and one out of every three to six first-time homebuyers purchased a home with the help of MRB financing. Since they first began homeownership programs in the early 1970's, State housing finance agencies (HFA's) have provided below-market rate mortgage loans for at least 440,000 households. In addition, local HFA's have provided mortgage loans for another 250,000 households. State and local HFA's together have provided well over $1 billion in low interest rate loans for home improvements and energy conservation for existing housing. In 1981, according to the Council of State Housing Agencies, MRB borrowers' median income was at 81 percent of the national median. In 1982, during the depths of the recession, borrowers' median income was still only at 96 percent of the national median income despite the use of the MRB program as a countercyclical device. Clearly, national income limits are unnecessary and would be problematic; national limits would not provide the flexibility to adjust local housing costs and personal income levels with local needs.

AFFORDABLE HOUSING ESSENTIAL TO ECONOMIC DEVELOPMENT

As a Governor, I can assure you that the tax-exempt revenue bond program at the State level is successful because it provides more than affordable mortgage money for our deserving citizens. Tax-exempt bonds for homeownership serve a larger role in relation to State economic development strategies. This program has been critical to the ability of our States affected by the significant shift of new population to the Sunbelt to respond to the need for new housing. It has also been essential for those States undergoing stress from the rapid development of their energy resources, such as Wyoming and Montana, to provide housing opportunities for the influx of labor needed to produce the energy this country requires. At the same time, tax-exempt bonds for homeownership have served as a stabilizing force for homeownership in the cities and the neighborhoods of our northeast and midwest. The redevelopment of our tax base in the industrial heartland is vital to the continued health of our national economy.

As Governors, we are responsible for the growth and productivity of both our economic and human resources. In the past 5 years, the ability of State housing finance agencies to produce lower interest rate funds for homeownership has meant an increase in affordable housing opportunity. The MRB program has maintained a faltering housing industry providing thousands of jobs in our construction and building materials industry. It is estimated by the Council of State Housing Agencies that new homes financed by State and local HFA's, about half of the nearly 700,000 homes financed by them, have created over 439,000 jobs, generating $3.7 billion in tax revenues and total economic activity of $36.6 billion. The MRB Program has allowed State government to pursue a strategy of economic growth rather than stagnation. It has given our citizens an opportunity to purchase their first homes.

PROVIDING CAPITAL FOR HOUSING

A substantial benefit of tax-exempt bonds is allowing the States to seek funds from capital markets to increase money for housing, thereby making money available to low and moderate income families who would otherwise be precluded from financing a home purchase. Because of the State access to capital markets, the States are able to provide the type of financing to meet the needs of the current economic climate. From the end of 1981 through 1982, mortgage money through State housing finance agency programs was virtually the only available and affordable financing. Now State programs are available to give the qualified consumer a low interest, low-downpayment, fixed-rate, 30-year mortgage which, as you know, is no longer economically feasible for many of our traditional lending institutions. As conventional interest rates are dropping, so are the interest rates of State programs allowing us to serve even lower income families.

LOW FEDERAL COST AND MAJOR STATE CONTRIBUTIONS

While the benefits of MRB's are significant, the cost to the federal government is relatively small. Moreover, States, themselves, have made major financial contributions to the program. According to an estimating method developed by Professor Roger Kormendi and Thomas Nagle, the cost of continuing the federal tax exemption for MRB's is $15 million in Fiscal Year 1984 up to $325 million in Fiscal Year 1988, for a 5-year total of $790 million. At the State level in 1982 alone, State housing finance agencies contributed $155 million to 61 single family housing issues. Part of these contributions came from earnings of the agencies and part came for State appropriations and loans.

NGA OPPOSES FURTHER RESTRICTIONS TO THE MRB PROGRAM

The National Governors' Association is vehemently opposed to the imposition of further restrictions on the MRB Program. In 1980 the Mortgage Subsidy Bond Tax Act virtually closed down the MRB Program for almost a year through a series of legislative restrictions and implementing regulatory limitations. Because Congress has subsequently made necessary adjustments, the program is operating smoothly. An additional disruption to the Program and the marketplace is unnecessary and will be problematic.

There is no need for further restrictions. On the one hand, the volume limitations imposed by the 1980 Mortgage Subsidy Bond Tax Act have not yet been approached. According to the Joint Committee on Taxation, in 1982 States could have issued $14,410 million in mortgage revenue bonds, but, in fact, they issued only $8,646 million of bonds, or less than 60% of the allowable level. And, on the other hand, there is no litany of abuses that must be corrected.

The National Governors' Association is opposed to conditioning the availability of the MRB Program upon the existence of a certain national mean mortgage interest rate. Such a trigger device would simply make the MRB Program unworkable. The MRB Program is administered by State and local housing finance agencies. A mandate to start-up and close down periodically the State program and agency can only produce chaos, instability, high cost, and slow response to market conditions. A national standard ignores diverse local conditions. Areas with high housing demand and capital shortage will suffer if the national mortgage interest level is below the trigger level. And the sudden availability of mortgage revenue bonds or the lack thereof will bring about dislocations in the bond market by causing sudden volume changes in municipal bonds.

MOST EFFECTIVE ALTERNATIVE AVAILABLE

What the MRB Program has done is to support effectively and efficiency the provision of housing for first-time homebuyers. Today, over 90 percent of bond proceeds are generally made available to first-time mortgagors. Neither the Department of the Treasury, the General Accounting Office, the Congressional Budget Office nor a Member of Congress has pointed to an existing federal program which achieves the objective better. To date, there is no cheaper or more workable alternative to the MRB Program. If one believes that the federal government should assist first-time homebuyers, one should support the MRB Program as does the National Governor's Association.

NGA supports the passage of H.R. 1176; and when H.R. 2673, the bill repealing the withholding of interest and dividends reaches Conference, NGA asks that you retain the substance of H.R. 1176, which has been added to the bill by the Senate.

PRESERVE THE INDUSTRIAL REVENUE BOND PROGRAM

Preserving the Industrial Revenue Bond Program is a high priority on NGA's legislative agenda. Two provisions of H.R. 1635, the Industrial Development Bond Limitation Act of 1983, are designed to terminate the program. Therefore, NGA opposes Sections 2 and 4 of H.R. 1635, but specifically takes no position on Section 3 of the same bill.

IRB'S ESSENTIAL STATE TOOL FOR ECONOMIC DEVELOPMENT

NGA is a strong supporter of having available tax-exempt industrial revenue bond (IRB) financing for State and local governments because such financing is an essential tool to promote community and economic development. Tax-exempt financing stimulates job creation, encourages business expansion and increases productivity. When so many federal economic development programs have been or are slated for termination, IRB's become almost the only tool available for financing business development in economically underdeveloped or distressed communities. In our present time of austerity, IRB's are a cheaper and more efficient economic development program than the direct federal expenditure programs that are now being cut back: They are available to a large number of jurisdictions. They provide greater local flexibility for matching funds with local economic needs. They cost less to administer, and they rely on the private market place for the lion's share of funding and the determination of project viability.

IRBs are so vital to State programs that every State issues at least one kind of revenue bond. In 1982, forty-eight States issued small issue industrial development bonds (IDBs), forty-one States issued pollution control bonds and forty-nine States issued multi-family housing bonds.

SEVERE RESTRICTIONS ON IRB'S IMPOSED BY TEFRA

The IRB Program was subjected to an extensive legislative review last year. As a result, Congress enacted the Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248) (TEFRA), which imposed a number of statutory restrictions on the ability of States and local government to issue tax-exempt IRB's. Such restrictions included:

(1) A requirement that all issuers of non-general obligation tax-exempt bonds make quarterly information reports;

(2) A requirement that all IRBs be approved by an elected official in the issuing jurisdiction and jurisdictions where the facility is to be located;

(3) A reduction in the depreciation allowances for IRB-financed property;

(4) A reduction in the length of the maturity of IRB issuances;

(5) A December 31, 1986 deadline for legislative reevaluation of the small issue IDB program;

(6) The elimination of the use of small issue IDBs with other tax-exempt issues;

(7) A prohibition against the use of small issue IDBs for certain recreational uses and limitations on their use for other recreational or entertainment purposes, for retail food and beverage services or for automobile sales or services; and

(8) A reduction in the kinds of small issue IDB composite issues permitted.

Most of the restrictions and requirements did not become effective until January 1, 1983. It is difficult, therefore, to determine their full impact. However, the abuses that have been cited by IRB critics in past years were directly addressed by TEFRA. To the best of the knowledge of the Nation's Governors, there have been no cited instances of similar abuses since TEFRA went into effect.

TEFRA CHANGES RESULT IN MAJOR IRB USE REDUCTION

A suggestion has been made that the use of IRBs is growing at a fast pace and must be curtailed to reduce losses to the federal treasury. Estimates of projected volume use of IRBs by the Joint Committee on Taxation and others for 1983 and beyond are high and fail to account fully for the impact of the changes to the law brought about by TEFRA. While the Internal Revenue Service has not made public first quarter information reports concerning tax exempt bond issuances, the result of the telephone calls we have made reports that industrial revenue bond volume is down drastically. Massachusetts reports that in the last quarter of 1982 it issued 87 new bond projects, but in the first quarter of 1983, after the effective date of the TEFRA changes, it issued only 19 new bond projects. The Connecticut Development Agency, another heavy IRB issuer, reports that in fiscal year 1982 (July 1, 1981-June 30, 1982) it approved $258.3 million in projects, but for fiscal year 1983 (July 1, 1982-June 30, 1983) it approved only $211.1 million in projects. According to the Public Securities Association, the first quarter of 1983 small issue IDB volume decreased by over 53% compared to the first quarter of 1982.

The foregoing data has led NGA to conclude that it is premature to add further IRB restrictions to reduce volume. First, the first quarterly information reports to IRS have not yet been compiled and analyzed so the national impact of the TEFRA changes are not yet accurately known. And second, to the extent we have information available, it appears TEFRA has already resulted in a significant decrease in IRB volume.

OPPOSE LENGTHENING DEPRECIATION PERIODS

NGA specifically opposes Section 2 of H.R. 1635 which lengthens the period of cost recovery for property financed with tax exempt bonds. Last year, the Senate Finance Committee recommended the same ACRS trade-off that is being proposed in this Section. The trade-off was considered and rejected by the full Senate. In debate it was recognized that such a restriction would do much more than merely limit the issuance of IRB's. Based on independent analyses undertaken of last year's proposal by the States of Mississippi and Missouri, only those few firms with severe capital needs and poor economic prospects would choose IRB financing over the use of ACRS. These unprofitable corporations would probably not be credit-worthy. In our estimation the effect of the forced choice would be few, if any, users of industrial revenue bonds. The Wall Street law firm of Hawkins, Delafied and Wood also examined the proposal. Its analysis concludes that:

"* * * for a profitable business in the 46 percent corporate income tax bracket which intends to occupy a building or use equipment for its useful life, IRBs would always constitute a more-expensive financing option on a present value basis than ACRS under the H.R. 1635 proposal. As the rational economic choice would favor ACRS depreciation, IRB's would not be pursued, effectively cancelling the program."

The Section 2 proposal closely follows on the heels of the ACRS trade-off included in TEFRA. The analysis by Hawkins, Delafield and Wood of the impact of that provision concludes:

"Under this limitation IRB financings have continued but at a lessened volume, in part due to the reduced benefits of using IRB's. Our estimates based on this and similar analyses indicate that one-half to two-thirds of the benefits of using IRB's without any ACRS trade-off have been eliminated by the TEFRA ACRS trade-off requirement. Because the benefits of IRB financing are directly proportional to the size of the issue, the benefits now of doing smaller issues are quite low in absolute dollar terms. This fact, as it becomes more understood, will hamper IRB issuance further, particularly by the small companies to whom the program is directed."

Based on the preceding analysis, NGA can only conclude that the purpose of Section 2 is not to reduce the loss of federal revenues but to eliminate the use of the IRB Program by profit-making organizations. This Section, then, starkly raises the issue of whether there should be an IRB Program at all.

OPPOSE CAPITAL EXPENDITURE RELATED LIMITATION CRITERIA

The National Governors' Association also opposes Section 4 of H.R. 1635 which imposes three additional limitations. There has been no demonstration that these restrictions are necessary.

Section 4(a) would limit the use of small issue IDBs to corporations below a certain size measured by their capital expenditures over a 3-year period, and it would limit the amount of small issue IDB financing that could be outstanding at anyone time. The stated purpose of those two limitations is to restrict financing to small businesses.

CBO, as indicated in its study issued in April 1981, and Treasury recognize that 84 percent of the dollar volume of small issue IDB's in 1978 and 1979 went to non-Fortune 1000 industrial companies and non-Fortune 50 non-industrial companies, and 93 percent of the number of small issue IDB's went to medium and small companies. The principal beneficiaries of small issue IDBs are already small businesses. In fact, the primary utility of IDBs is their effectiveness in increasing investment in small businesses that provide such a large percentage of this Nation's employment, entrepreneurial initiative, and increased productivity.

The impact of the limitations contained in Section 4(a) would be to cut-off small issue IDB financing from some of our strong, fast growing companies which are small but whose recent rapid expansion pushed them over the limit. The result would be to cut-off financing from those small businesses which are creating the most jobs at the fastest rates and are stretching the limits of their present capacity and productivity.

Using capital expenditure limitations of $20 million is both arbitrary and unwieldy. Why choose a $20 million cut-off? Why use capital expenditures as the measurement of size? Many companies do not keep records of capital expenditures, particularly on a worldwide basis.

It is ironic that the stated purpose of Section 4(a) is to limit small issue IDB's to small businesses when the impact of the ACRS trade-off enacted in TEFRA last year was to make it unprofitable for small businesses to utilize small issue IDB's for small loans.

OPPOSE LAND REGISTRATION PROHIBITION

NGA also opposes Section 4(b) which prohibits the use of small issue IDB's for the financing of land. No rationale or abuses are cited which lay the foundation for excluding land acquisition from being financed with small issue IDBs. Land is often an important element of small issue IDBs for smaller companies, that need the proceeds to finance land along with buildings and equipment. Many small corporations will have difficulty financing land purchases with internally generated cash.

OPPOSE VOLUME RESTRICTIONS

Another restriction not in the bill that has been discussed is the possible imposition of a State cap on IRB volume. That concept was explicitly rejected as unworkable during the consideration of TEFRA last year. NGA again strongly opposes any attempt to place volume limitations on each State.

IRB'S NOT CROWDING MUNICIPAL BOND MARKET

Suggestions have arisen that the federal government should protect the States from crowding the municipal bond market with too many industrial revenue bonds. The thesis is that an increasing volume of industrial revenue bond is increasing the borrowing costs of State and local governments and decreasing the interest rate spread between tax exempt and taxable bond issues.

A recent survey conducted by the Morgan Guaranty Bank's Municipal Securities Research Group concluded:

"Interestingly, despite the enormous increase in the amount of State and local debt outstanding, the burden of debt in 1981 declined to a level below that of 1970 in relation to Gross Nationl Product (GNP) and personal income. New issuance, especially since 1976, has not kept pace with general indicators of economic activity and retirement of outstanding debt.

"Most of the growth occurred in the first half of the decade with a marked deceleration of growth after 1976. By comparison GNP in current dollars and personal income grew steadily throughout the decade.

"The decline in debt burden combined with the trend toward lower tax burdens during the same period suggests that States have some debt issuance capacity."

Henry Kaufman of Salomon Brothers in analyzing the crowding of the municipal bond market lists a number of factors that have affected it. The largest difficulties for the market are created by "the onslaught of an imbalanced national economic policy which, on the one hand, stimulates fiscally and on the other, restrains monetarily." It is the huge issuance of U.S. government securities that creates the greatest problem. But extensive borrowing by large business corporations is not far behind. The flexibility of the U.S. government and large corporations to raise funds from the shortest to the longest maturities gives them significant advantages over State and local governments. Another major factor is the recent tax cut legislation (ERTA) which put State and local governments at a disadvantage by reducing the value of tax-exempt income relative to taxable income. Other factors hurting municipal securities include the reduction of income from federal grants-in-aid, the availability of the All-Savers Certificate, the weakening of State and local credit quality, the availability of other tax shelters, and the need by banks and insurance companies to purchase tax-exempt bonds to reduce their taxable income.

The facts show that tax-exempt bond volume is not the primary influence on tax exempt rates. The capital markets are too complex for a single factor like volume to dictate the cost. Perhaps the most significant factor, however, is the amount of purchasing or selling of tax exempt securities by banks and insurance companies. Based on Federal Reserve data, one can see the nearly constant relationship between the tax-exempt bond purchase cycle of banks and insurance companies and tax-exempt bond rates. When these institutions are active purchasers, tax-exempt rates drop as bonds are bought. When these institutions' profits drop, their purchases decrease and municipal rates must rise to find new buyers, particularly individual taxpayers.

Finally, it is only reasonable to expect that States and localities would reduce or cease issuing industrial revenue bonds, which they have not, if the issuance of those bonds impaired their ability to issue general obligation bonds for general governmental purposes.

REJECT IRB RESTRICTIONS

NGA is convinced that there is no need to further restrict industrial revenue bonds, and, therefore, it is firmly opposed to Sections 2 and 4 of H.R. 1635. The debate and the inclusion of the sunset provision for small issue IDBs enacted in

TEFRA last year made it clear that small issue IDB's, should not be reevaluated until 1986 when data on the effect of the TEFRA changes will be available. However, based on the preliminary data it has gathered, NGA would certainly favor the elimination now of the ACRS trade-off and the sunset provision for small issue IDBs enacted last year if the Congress is to act.

Mr. Chairman, NGA would be glad to entertain any questions the Committee may have.

STATEMENT OF HON. RICHARD H. BRYAN, GOVERNOR OF NEVADA

Mr. Chairman and Members of the Committee: I strongly urge that H.R. 1176 and its companion bill S. 137 (the Housing Finance Opportunity Act of 1983) be passed into law. As the Governor of Nevada my comments will focus upon certain policy perceptions concerning the continuation of mortgage revenue bond financings as this Act would provide.

The continuation of mortgage revenue bond financing provides a clear public benefit on two fronts. First, bond issues of this nature alleviate a shortage of owner-occupied housing which eligible families may purchase and, second, these bond programs increase housing production, which serves as a mechanism of job formation. An often unrecognized tertiary benefit of mortgage revenue bond financing is the addition of new tax revenues through expanding real property rolls and actual increases in wealth and income created by added housing production.

In 1975, the Legislature of Nevada recognized that there was, and would continue to be a shortage of safe, decent, and sanitary housing that private enterprise could not provide by itself. The people of Nevada, acting through their representatives, determined that a true public would be served by establishing a Housing Division in the State Department of Commerce to issue tax-exempt mortgage bonds in order to obtain below market interest rates for assisting low and moderate income families in the acquisition of affordable residential housing.

The Housing Division has taken its creation as a serious responsibility and has conscientiously undertaken to issue mortgage revenue bonds for public purposes within its statutory authorization. The State of Nevada is proud of the Housing Division and its efforts of benefit only those low to moderate income families who could not otherwise obtain financing of residential housing from private capital sources.

The Division sets program guidelines for sales prices and eligible family incomes based entirely on data supplied by the U.S. State Department of the Treasury and the U.S. State Department of Housing and Urban Development. Sales price limits are set below the safe harbor limitations issued by the Internal Revenue Service. In the case of new construction, the limits are $6,600 below IRS guidelines. Existing residential sales prices are $8,400 below IRS levels. Income guidelines are set for families ranging in size from one person to five or more. The Division sets gross annual maximum allowable incomes for its single family programs on a statewide basis upon 120 percent of HUD median income. The relationships among family size categories is based upon seciton 8 relationships. The gross allowable incomes include IRA and KEOGH accounts in the calculation of eligibility.

The actual sales price limits represented by the Division's loan portfolio for the years 1978-1982 are below the established IRS guidelines. Thirty percent of the purchase prices in the Division's files are between $40,000-$49,999, while 43 percent are in the $50,000-59,999 range. None of the loans carry purchase prices at or near the safe harbor limits.

Historically, the Division has thoroughly underwritten the eligibility of borrowers for each of its programs. The statuory purpose of serving only those families who cannot compete in the private sector mortgage market is the guiding principle. Since 1978 the Division has financed over 3,900 loans. 80 percent of these loans are below the HUD median income level. Considering the loan portfolio held by the Division for the years 1978-1982 inclusive, 47 percent of the Division's borrowers had family incomes between $15,000-$19,999. Borrowers with family incomes between $20,000-24,999 represent 30 percent of the loan portfolio. Only 20 percent of the Division's borrowers approached the gross maximum allowable income level.

The greatest percentage of Division borrowers, therefore, had incomes well below the allowed levels. As the data suggests, Nevada is firmly committed to encouraging and supporting single-family residential housing opportunities for low and moderate income families.

There exists a continuing need for mortgage revenue bond financing in the State of Nevada. Nevada's housing problems have been created by its enormous population growth since 1970. The population growth of Nevada continues at a pace which is five times faster than that of the nation. Nevada grew by 63 to 64 percent from 1970 to 1980 while the nation's population grew by 7 percert. This rapid growth in population, coupled with a shortage of privately owned land and high building costs, have placed single family home ownership beyond the reach of most of Nevada's moderate income families.

Population estimates and projections for Nevada reflect a high potential demand for housing production. The table below reports the current population and near term estimates predicated upon recent trends.

POPULATION ESTIMATES

Area	1982	1985	1987	1990
Las Vegas	512,021	573,397	639,416	752,965
Reno	208,321	237,268	264,586	311,572
Rural	129,180	171,951	198,439	233,680
Total	886,543	988,616	1,102,441	1,298,217

At 2.63 persons per household, (the statewide estimate from the 1980 census) new housing unit requirements total nearly 38,900 in 1985, almost 43,300 in 1987, and some 74,500 in 1990. Nevadans, by nearly a 3 to 1 margin have always chosen the owner-occupied market to the rental, if the opportunity was available. This opportunity must be preserved.

Data available to the Division for the last quarter of 1983 suggests that the housing affordability profile for the Las Vegas area in relation to household incomes exhibits a significant void in the ranges supplied by the Housing Division as a result of the Division's mortgage bond programs. Specifically, the $40,000–$65,000 per unit range.

Demand for single-family housing units remains high, (about 5,000) units even in light of the recent period of slow growth in the regional economy. An absorption rate of about 1,000 units per year is a likely reflection of this demand. However, because of the void in sales prices noted above, and the cost of money absorption is below what demand would suggest. New construction appears to float, for the most part, in the $77,000–$95,000 per unit range. The Housing Division's programs will, if allowed to continue, drive the price downward as a function of providing a guaranteed takeout loan for this segment of the market.

In the Reno market, the shortage of affordable housing opportunities remains critical. During 1982 less than 500 new units were authorized. A comparison of income ranges with available housing indicates that the greatest void in the Reno housing market is at levels which would be priced for family incomes at or near $25,000 per year. These eligible families are the Division's target. The continuation of the Division's single-family programs will, again, influence this problem by creating a "guaranteed" market for the construction of housing at prices at or below $75,000 per unit.

Nevada has always been an importer of capital. A principal purpose of the Division's bond programs is to provide a source of mortgage money which cannot be supplied by the private sector. In the Housing Division's single family programs, lending institutions apply for a reservation of mortgage funds. The amounts requested presumably indicate the shortage of funds which the private sector cannot supply or is unwilling to supply to meet the needs of low to moderate income families. Allocation requests received from lending institutions for mortgage funds were $234 million in 1978, $150 million in 1979, more than $175 million in 1980 and exceeding $75 million in 1982.

The Nevada Housing Financing Law requires that prior to the issaunce of any bonds for the purpose of financing single or multi-family housing, the Administrator must find that:

Private enterprise and investment have been unable, without assistance, to provide an adequate supply of decent, safe and sanitary housing in such housing market area at rentals or prices which persons or families of low and moderate income can afford or to provide sufficient mortgage financing for residential housing for occupancy by such persons or families.

This goal is also reflected in the Housing Division's single family program documents. The Housing Division will purchase only those loans which are made to persons who would not otherwise qualify for conventional loans. Each lending institution must represent and warrant that each mortgage loan is in addition to and not in substitution for, residential loans which it otherwise would have made in the State of Nevada.

Allocation requests from the private lenders, savings and loan associations, banks and mortgage bankers are an important element in the determination of what portion of the State's housing capital they must rely on the Housing Division to fulfill. When capital is no longer necessary, lenders will not request funds from the Division and no mortgage revenue bonds will be issued by the Housing Division.

Analysis by the Nevada Housing Division is also conducted to determine the amount of capital and ratios in the market. A Division survey of lending institutions in the state indicated that the typical savings and loan association loan with government guaranteed mortgaged insurance generally requires 5 percent down and bears interest at 12 percent plus 3 points. The typical conventional savings and loan association loan is 12.78 percent with 3 points. The qualifying housing expense to income ratio is 25 percent PMI to 28 percent and the qualifying overall living expense to income ratio is 35 to 38 percent.

Due to the popularity of money market deposit accounts, savings and loans and mutual saving banks had more new deposits last December ($16.6 billion total, or a $199.6 billion annual rate) than in all of 1981. After their authorization in the last two weeks of December, these deposits rose by $38.8 billion at savings and loans and $9.3 billion at mutual saving banks. (About $31–32 billion came from other deposits at these thrifts, and some came from money market mutual funds, which declined by $20 billion in the last three weeks of December.)

Both the money market deposit accounts and the super NOW accounts, authorized in January, are continuing to grow rapidly, although the latter are not as popular as the former is, it would appear that there will be no problem with availability of funds at thrifts to finance mortgage lending this year.

The real issue, however, is what these new accounts will do to the cost of funds, and thus to the mortgage interest rates that thrifts are likely to charge. The cost of funds at savings and loans in the first half of last year (latest available data) was 11.5 percent. The rates paid on the new accounts vary, but seem to be in the 8–10 percent range. These higher rates will probably drop somewhat as competition settles down, assuming of course that the structure of money market rates does not change dramatically. Therefore, it would appear as though the average cost of funds will decline sufficiently to allow for mortgage rates to hold around 13 percent in the conventional market. Government guaranteed loans will, naturally, remain below 13 percent. But not at levels the state can provide.

The historically typical Housing Division borrower has a loan of $45,000 with a loan to value ratio no less than 95 percent. His or her housing expense to income ratio is typically in excess of 35 percent. While it is likely that the price of shelter in today's market will be above the $45,000 level, it is also likely that in today's market the typical Division borrower will have little access to mortgage money outside of the Division. Thus, private enterprise is unable to supply mortgage loans at intersest rates and on terms that eligible families, under Division policy and state mandate, can meet.

It remains, therefore, critically important that states be allowed to maintain their position in the mortgage market. In this way, both lower cost housing production and lower cost money may be encouraged and provided.

Mortgage revenue bonds provide public benefits not just from the provision of affordability for low and moderate income families in the market, but from the expansion of the construction industry, the increase of real property tax rates, and the importation of capital. Each of these secondary and tertiary benefits provide an economic multiplier which must be considered in any cost effectiveness agreement and not simply ignored in the face of an alleged federal revenue loss. The expansion of investment and productivity resultant from activity generated by housing revenue bonds creates additional tax revenues. Further, when considering the nature of the investor in tax-exempt financings it may be concluded that the absence of mortgage revenue bonds will generate demand for other forms of tax-exempt securities or, at least, a new form of tax-shelter to offset the necessitated investment in taxable securities. The arguments reflecting upon the cost-effectiveness of mortgage revenue bonds will be further quantified in companion testimony from the Council of State Housing Agencies, of which the Housing Division is a member.

As a member of the Nevada Legislature I sponsored the Nevada Housing Finance Law which created the Housing Division. I believed then, and I still believe that single family housing must continue to be a major component of the housing stock of Nevada. As a state policy I do not believe that low to moderate income families should always be tenants rather than owners of modest homes. The development of affordable single family housing for these families must be encouraged.

Government at all levels, and the private sector as well, have an obligation to promote forms and processes of housing financing, that enhances access to housing for all families, including the poor and minorities. The opportunities this country has provided for citizens to move up socially and economically have been based in large part on an adequate housing supply. When the housing supply is restricted, especially housing affordable to those of low and moderate incomes; social, economic and geographic mobility is limited. Now only are moves to better neighborhoods more difficult, but people cannot find homes near suitable job opportunities, thus compounding the barriers to mobility.

The Housing Division has stressed adherence to its statutory mandate of providing housing for Nevada's low to moderate income families. The continuance of the Housing Division's ability to provide this housing opportunity and to further the state's housing goals in general is the end to which I am submitting this statement. Accordingly, I respectfully request favorable consideration of H.R. 1176.

STATEMENT OF BRIAN McKAY, ATTORNEY GENERAL, STATE OF NEVADA

I am strongly in favor of H.R. 1176, and its companion bill in the Senate, S. 137. H.R. 1176 is now in hearings before this House Committee on Ways and Means. The bill seeks to cure one of the most onerous defects in the so-called "Mortgage Subsidy Bond Tax Act of 1980" (Public Law 96-499), (hereinafter referred to as the "Act"). As a result of the Act, the internal revenue code now states in 26 U.S.C. 103A(c)(1)(B) that the interest earned on state and local mortgage revenue bonds issued for the purpose of financing owner-occupied residences will not be exempt from income taxation under the internal revenue code if such bonds are issued after Decembr 31, 1983. Withour such tax exemption, the State's cost of money will be too close to the prevailing private sector mortgage interest rates for the State to provide loans to persons of low and moderate income.

As chief legal advisor to the State of Nevada, my comments will focus on the legal implications of the Act in general and the above referenced section in particular. I am advised that other State officials will address the serious policy and political questions raised by the Act.

The United States Constitution grants the federal government the "Power tc lay and collect Taxes * * * (and) To make all Laws which shall be necessary and proper for carrying into Execution the foregoing Powers" in Article I Section 8. This seemingly unlimited power is restricted in part by the Tenth Amendment to the Constitution which states "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people".

In interpretating these constitutional provisions, the Supreme Court has developed the doctrine of intergovernmental immunity. In *Weston* v. *City Council* (1829) the Supreme Court struck down a city personal property tax on federal obligations, reasoning that it was a tax on "an operation essential to the important objectives for which the government was created . . . it is a burden on the operations of government". *Weston* v. *City Council*, 2 Peters (27 U.S.) 449 at 467–469 (1829). This immunity was reciprocally applied to state securities in the case of *Merchantile Bank* v. *New York* (1887). *Pollock* v. *Farmers' Loan and Trust Company*, 157 U.S. 429 (1895) made it clear that this reciprocal immunity extended to the interest income earned on state securities. In the Pollock case the Court examined the income tax law which Congress enacted in 1894. That law subjected the income derived from state, county and municipal securities to federal income taxation. The Supreme Court held at page 451 that "the authorities fully sustain the proposition that Congress cannot tax the borrowing powers of the States or their municipalities; for clearly if the right to tax existed, it would place the borrowing power of the States completely at the mercy of a majority in Congress (citations omitted)". The Court's decision in Pollock was unanimous on the point that state and municipal bonds were exempt from federal taxation.

In apparent response to the pollock decision, the 16th Amendment was adopted. The sweeping language of the 16th Amendment could be read so that it would eliminate not only the apportionment requirement of the Pollock decision but also that part of Pollock, and prior cases relied on therein, which stated that state and municipal borrowing was immune from federal taxation. Rather than chance rejection of the amendment, Congress made it clear that such was not the case. c.f. 45 Cong. Rec. 61st Cong. 2d Sess. Part 3, Pages 2539–2540; Part 2 Pages 1694–1698; and Part 3

Pages 2245-2247. That the purpose of the 16th Amendment was to overrule the apportionment ruling but not the immunity ruling in Pollock was affirmed by the Supreme Court in the case of *Evans* v. *Gore* (1920). The Congressional promise of 1910 thus became the law in unequivocal terms in 1920; the securities of states and their municipalities remained as immune from federal taxation after the adoption of the 16th Amendment as they had been after adoption of the original Constitution.

The Pollock holding was again reaffirmed in a case questioned the constitutionality of a tax on the gains derived from trading in municipals, *Willcuts* v. *Bunn* (1931). The opinion states at Pages 224 and 225 of 282 U.S.:

The well-established principal is involved that a tax upon the instrumentalities of the States is forbidden by the Federal Constitution, the exemption resting upon necessary implication in order to effectively maintain our dual system of government . . . And a tax upon the obligations of a State or of its political subdivisions falls within the constitutional prohibition as a tax upon the exercise of the borrowing power of the State.

In the recent case of *Massachusetts* v. *United States,* 435 U.S. 444 at 454 (1978), after a lengthy review of the intergovernmental immunity doctrine, the Court, at page 459, succinctly concluded that "the purpose of the implied constitutional restriction on the national taxing power is * * * to protect the States from undue interference with their traditional governmental functions". In another recent case the Court had occasion to comment on the vitality of the intergovernmental tax immunity doctrine, albeit in a non-tax case, in its widely quoted opinion in *National League of Cities* v. *Usery,* 426 U.S. 833 (1976). The Court stated:

This Court has never doubted that there are limits upon the power of Congress to override state sovereignty, even when exercising its otherwise plenary powers to tax or to regulate commerce which are conferred which by Art. I of the Constitution. (at 842).

The (Tenth) Amendment expressly declares the constitutional policy that Congress may not exercise power in a fashion that impairs the States' integrity or their ability to function effectively in a federal system . . . (at 843).

The Court continued at page 847, that the vice of the federal statute there being examined was that "quite apart from the substantial costs imposed on the States and their political subdivisions, the Act displaces state policies regarding the manner in which they will structure delivery of these governmental services which their citizens require." The Court repeated at pages 851 and 852 that the vice of the federal statute being examined was that it would "impermissibly interfere with the integral governmental functions of (the states)," concluding that under our Constitution the federal government may not "wield its power in a fashion that would impair the States' ability to function effectively in a federal system."

State housing finance programs using mortgage revenue bonds to assist low and moderate income persons to obtain housing they would otherwise be unable to afford have been found to serve a valid public purpose by many state supreme courts. Such a decision of the Iowa Supreme Court in the case of *John R. Grubb, Inc.*, v. *Iowa Housing Finance Authority* in 1977 contains a lengthy description of similar State Supreme Court decisions in Alaska in 1966, Illinois in 1948, Maine in 1971, Massachusetts in 1969, Minnesota in 1973, New Jersey in 1970, Rhode Island in 1973, Vermont in 1970, West Virginia in 1969, and Wisconsin in 1973.

In 1975, when adopting our Housing Finance Law, the Nevada Legislature made specific findings, including that:

There exists a serious shortage of decent, safe and sanitary housing in this State available to persons and families of low and moderate income * * * This condition is conducive to disease, crime, environmental decline and poverty, impairs the economic value of large areas, which are characterized by depreciated value, impaired investments, reduced capacity to pay taxes, and lack of new development to meet the needs of area residents, and is a menace to the health, safety, morals and welfare of the citizens of this state * * * It is difficult and uneconomic for individual owners independently to remedy this condition * * * The ordinary operations of private enterprise have not in the past corrected these conditions * * *. It is necessary to create a housing division in the Department of Commerce to encourage the investment of private capital and stimulate the financing of housing through the use of public financing to provide mortgage loans and to make loans to and purchase mortgage loans from mortgage lenders. All the(se) purposes * * * are public purposes and uses for which public moneys may be borrrowed, expended, advanced, loaned or granted. Nevada Revised Statute 319.020.

The Nevada Housing Finance Law, in section 319.060, limits the class of persons eligible for assistance to those persons who have insufficient income to compete successfully in the private unassisted housing market.

I firmly believe that it is the right of the State of Nevada to analyze its housing conditions and to determine which class or classes of residential housing may be in need of assistance. At the time the Nevada Housing Finance Law was enacted it was firmly believed, and continues to be, that it is within the traditional role of state government to designate the promotion of single-family home ownership by persons of low to moderate incomes as a valid public purpose.

To the extent the Act limits the class of persons of low and moderate income the State may assist, it may well prove to be an unconstitutional restriction of a traditional state governmental function. The December 31, 1983 sunset provision, however, presents a much clearer case. If sunset occurs, i.e. if H.R. 1176 does not pass, States will not even be able to serve the low to moderate income home buyers targeted for such assistance by the Act. At least to the extent of such targeted home buyers the Act is an express acknowledgement that a State housing finance program like Nevada's is an appropriate governmental function since Nevada's housing assistance program is limited to the targeted class. It is therefore hard to imagine how the sunset provision could withstand a constitutional challenge in light of the case law described above.

To summarize, I urge you to give favorable considration to H.R. 1176, so that the Mortgage Subsidy Bond Act of 1980 can continue to serve the purpose for which it was intended. Should you fail to give favorable consideration to H.R. 1176, I am confident that we will be able to successfully challenge the objectionable sunset provision of the Act on constitutional grounds. However, in recognition of legal reality and fiscal responsibility, I would hope that your positive action would make it unnecessary to litigate.

Thank you for this opportunity to state my support for H.R. 1176.

STATEMENT OF JAMES J. HUGHES, JR., EXECUTIVE DIRECTOR, NEW JERSEY ECONOMIC DEVELOPMENT AUTHORITY

It is time to return to fundamentals on the matter of industrial development bonds (IDBs) and we therefore respectively request this committee to reject this bill on at least two grounds.

First, the real question at hand is not whether further to curtail IDBs or to improve their usage in the national economy, but rather whether small issue industrial development bonds should survive at all.

After deliberating revenue bills for the past two years, it is a reasonable conclusion that the sense of Congress is that it is not desirable to eliminate small issue industrial development bonds at this time.

But IDB opponents have not rested. As another means toward eliminating IDBs, opponent have adopted the strategy of burdening the IDB with numerous restrictions, requirements, and qualifications—all under the banner of "improvement." In this way, use of the IDB will gradually vanish because of the weight of detailed and complicated considerations which are costly, time consuming, and unpredictable in outcome.

There is no surer way to discourage a business undertaking than by red tape, regulations, delay, high cost, and unpredictability. And there is no surer way to discourage the concomitant capital formation which the nation so desperately needs.

In our opinion, even if "improvement" is the motive for H.R. 1635, the result will be to choke the IDB to the point of extinction.

Just nine months ago Congress enacted a rectifying bill, "The Tax Equity and Fiscal Responsibility Act of 1982" (TEFRA), later approved by the President, which contains numerous requirements curtailing and governing the use of industrial development bonds, particularly small issue development bonds.

Speaking as the largest single issuer of IDBs, we find the TEFRA rules and regulations to be burdensome with inevitable delay, uncertainty, and procedural disruptions. Our IDB activity has been severely impacted by TEFRA:

Dollar volume of industrial bond closings by the New Jersey Economic Development Authority to date in 1983 is 39 percent lower than for the same period in 1982.

Even if our 1982 dollar volume is adjusted downward to eliminate one unusually large exempt project (under 103(b)(4)), our 1983 dollar volume to date is down 11 percent.

H.R. 1635 adds still more rules and limitations which necessitate onerous administrative tasks on the part of both business firm and issuer. The stultifying effect on capital formation and business expansion will be far worse than TEFRA.

Second, I suggest to the members of this committee that the industrial development bond is the most effective and efficient economic development program which federal law provides. The IDB is local, quick acting, and responsive to economic needs. There is no federal administrative staff, no thousands of lines of fine print regulations, no federal evaluation staff, no federal inspector general, and no outlay of federal funds. No other federal economic development program can boast all of these highly desirable elements.

In 1982, an estimated 11,535 permanent new jobs in New Jersey were associated with industrial development bonds for 456 projects. Seventy percent (70%) of these new jobs were industrial, providing a vital replacement for some of the 140,600 manufacturing jobs lost in New Jersey since the peak in 1973. In addition, 8,800 full-time construction jobs were associated with these IDB issues. A considerable number of jobs saved also are associated with these IDBs, but these are not included in this count. Not one cent of federal money was spent for these results.

We feel these two considerations are sufficient cause to reject this bill. However, there are still further reasons to reject this bill.

Our extensive studies offer strong evidence that the federal tax revenue flowback from IDB beneficiaries is about three times greater than the alleged revenue "loss" attributed to the IDB tax exemption. Federal tax spokesmen erroneously assume that every dollar of IDB investment would instead go to fully taxable investments.

Worse, is the erroneous assumption on the part of IDB opponents that "the projects would get built anyway". We assure this committee, from a very large and representative base of operating experience, that absolutely is not the case. It is impossible to determine definitively through quantitiative methods, for almost all projects, whether "they would get built anyway". The best way to attempt such a judgment is to inquire of those who see IDB applicants and their business circumstances first hand.

We see many, many businessmen and busineswomen in our office struggling for such savings as afforded by an industrial development bond in order to proceed with their project—usually an expansion in place. An independent judgment of the circumstances in these cases would conclude that many businesses, small, medium, and large, would not proceed with the project except for the lower costs derived through the industrial development bond.

VOLUME

We all know by the May 1983 Report of the Congressional Budget Office that the growth of small issue industrial development bonds has not recently been "explosive". CBO reports that small issue IDB volume from 1981 to 1982 remained practically the same. Taking Assistant Secretary Chapoton's figure of $85.8 billion as the total of long term 1982 tax-exempt bond issues, and the Congressional Budget Office figure of $12.7 billion as the total of 1982 small issue industrial development bonds, we see that small issue IDBs are only 15 percent of the tax-exempt market, not the horrendous portion unfairly inferred by some spokesmen.

Moreover, total long term tax exempts increased by 51 percent in 1982 over 1981, according to Assistant Secretary Chapoton, while small issue IDBs increased less then 1 percent in 1982 over 1981, according to the CBO.

With these facts it is grievously fallacious to point with alarm to either the "detrimental" market effect of small issue IDBs or to their "explosive" growth.

Now, with TEFRA in effect and a pronounced narrowing of the interest rate spread between IDBs and taxable rates, no one can justifiable predict that small issue IDB volume will be "explosively" grater in 1983 than in 1982. Informed observers estimate that even with an expanding national economy we can expect 1983 small issue IDB volume will be about the same as, or less than, 1982.

We are disappointed that Congress seems to be overlooking the requirement in TEFRA for national reporting on the use of IDBs. Would it not be prudent to see this data for a period of operations of at least one full year before arriving at any judgments based on volume? Even better for this purpose would be to see results for the whole period through to sunset.

We feel confident that, when looking at this reliable body of data, we will not see any explosive growth, and we will not see so-called abuses, but we will see plenty of constructive projects, especially in the industrial sector, that would not have been possible without the IDB.

STATE CAPS

The prospect of enacting "state caps" governing the use of IDBs is truly an economic and administrative nightmare. What possible good can be accomplished by such a measure? If your answer is that it will hold down the volume of IDB issues, we see from the foregoing that such is not necessary.

Here are some indicative problems generated by the state caps idea:

A local IDB issuer will be baffled as to whether a proposed issue is or is not within a state cap.

Confusion will reign as proposed issues get close to the cutoff.

The Treasury will be in disagreement with issuers' determinations. This will create congestion in all jurisdictions while the ponderous process of federal decisionmaking goes on.

Recordkeeping will be controversial and will require constant federal refereeing. This will create further congestion in all jurisdictions.

Projects approved within the cap, but not closing when scheduled, will block projects of compelling time requirements outside the cap.

The sudden necessity for 50 states individually to comply with state cap legislation will be chaotic and prolonged in time; quite possibly the IDB will disappear.

On top of these problems relating to the IDB, is the even greater complexity associated with a state cap to apply to all tax-exempt bond issues.

Prompt action, definite answers, and reliability are essentials in the business world. When these elements are absent, business loses the will and capacity to proceed. State caps will ruin the IDB in all jurisdictions.

Aside from the administrative impracticalities, state caps are brutally unfair. There would be no gain to the nation. The assertion that state caps would halt a supposed increasing loss of federal revenue does not apply in the case of IDBs because of TEFRA and its sunset provision, among others. All that would happen under state caps is a crushing loss of business investment in those states which are now comparatively large users of the IDB. Those states which are now comparatively smaller users of IDBs would gain nothing over what they now can do.

CONCLUSION

For too long now the industrial development bond, especially the small issue industrial development bond, has suffered criticism which applied only to a very small percentage of total IDBs issued.

For too long now the administrative and programmatic efficiency of IDBs has been ignored.

For too long now the power of industrial development bonds to create and save jobs and produce tax revenues at all levels has been cast aside.

For too long now preposterous criticism of the IDB as a "revenue loser" has been accepted by officials without proper examination.

For these reasons, members of the committee, we ask you to reject H.R. 1635.

STATEMENT OF HON. RICHARD F. CELESTE, GOVERNOR OF OHIO

This testimony is offered in support of H.R. 1176 which would repeal the December 31, 1983 sunset date on the issuance of mortgage revenue bonds.

OHIO EXPERIENCE

In November, 1982 Ohio voters passed State Issue One giving the state the authority to issue mortgage revenue bonds (MRBs) to be used to provide mortgage loans for affordable housing. The vote was 1,827,453 (57.4 percent) to 1,356,336 (42.6 percent).

In January, 1983 the Ohio Legislature passed the implementing legislation which created the Ohio Housing Finance Agency (OHFA). The OHFA became responsible for writing program guidelines, for issuing the tax-exempt bonds, granting the loans, and overseeing the program.

In early May, the OHFA sold $300 million in mortgage revenue bonds and was able to offer 30-year fixed rate mortgages of 9.98 percent—the lowest rate in five years.

On Monday, May 23, 124 lending institutions across the state opened their doors to take applications on a "first-come, first-served" basis. The demand for these loans was so great that people began lining up at the lending institutions on the Friday before and stayed throughout the weekend. Within hours of taking applications on May 23, virtually all the money in the non-targeted areas was gone.

To date, 4,771 Ohioans have loan applications in process; the average loan sought by these applicants is below $42,000 and a family with an income of about $20,000 would meet the credit standards for a mortgage of that amount. Another 1,442 prospective homebuyers who have met qualification requirements are on a waiting list.

These numbers represent loan requests of over $300 million—far more than we were able to accommodate with our first program.

I am proud of the Ohio program which was the largest of its kind in the nation's history and completed in record time.

The Ohio experience reinforced my conviction that this is a program that meets the needs and demands of Ohioans for low-interest financing that will at the same time stimulate economic activity. The authority to issue bonds was passed with the help of middle income Ohioans who have been priced out of the housing market for the last 3 to 4 years.

Industrial revenue bonds and mortgage revenue bonds used by Ohio have been labeled "private purpose" bonds. On the contrary, when Ohio voters passed State Issue One, they decided that affordable housing is a public purpose and the state should assist in the public issue.

Mortgage revenue bond financing in Ohio briefly unlocked the stranglehold of high interest rates and, for the first time in five years, made housing affordable for thousands of families. At the same time, our program has created thousands of jobs in Ohio, generating business for an ailing housing industry and giving a boost to the state's economy.

WHY H.R. 1176 SHOULD BE PASSED

(1) People can not and will not buy houses at the present prevailing interest rates of 12.5 to 13 percent with 20 percent down and additional monies required for closing. If they could afford those interest rates, the housing industry would not have experienced the terrible slump of the last few years, nor would we have seen approximately 6,500 Ohioans waiting in line for 9.98 percent loans on May 23.

Tens of thousands of Ohioans are being denied access to the American dream of owning their own home because of federally-caused high interest rates. Today only MRB financing brings home ownership within their reach.

(2) The economies of Ohio and other states badly need the stimulus provided by the infusion of low-interest mortgages. In Ohio, a portion of the $300 million was available to be set aside for builders and will be in any future Ohio MRB issue. Only with a recovery in our construction industry will we see a recovery in our economy as a whole.

(3) Mortgage revenue bonds are the only available program for states to provide low-interest loans.

(4) MRBs let the state shape a program to fit its need. We put together our program in record time and still were able to tailor it to Ohio's needs. For example, there is great interest in Ohio's older urban areas, especially in the rehabilitation of single family homes. We were able to address that interest in Ohio's program; few other states have done so. Also, our guidelines reflect common practices found in Ohio's lending institutions, thus eliminating excess paperwork and providing a smooth application process for prospective homebuyers.

GAO REPORT

On April 18, while Ohio was in the midst of putting together its first bond package, the General Accounting Office issued a preliminary report on the costs and benefits of single family mortgage bonds.

We take exception to a number of the conclusions by the GAO. The GAO states that MRBs drive up the cost of other municipal bonds. But the MRBs issued in 1982 were less than three percent of the total outstanding tax exempt bonds. The volume of MRBs is already capped by the federal legislation, on a state-by-state basis, so there will not be unrestrained growth. Nor do MRBs crowd general obligation bonds out of the market; high interest rates do that.

The GAO also suggested that those participating in the program could have afforded the homes without the benefit of low-interest loans. That argument flies in the face of the condition of the housing market as we have seen it in Ohio.

Many of the families who sought mortgages on May 23rd were working couples between the ages of 25 and 35. Without MRB financing, they were not in a position to buy or construct a home. They simply could not afford the current high interest rates and therefore were willing to stand in long lines for three days to obtain an affordable home.

Ohio placed no income guidelines on those participating in the program. There were none because there is a strong correlation between the price of the home where limits are placed by the IRS and the income of the home buyer, illustrated by the mortgage size and income figures cited earlier. The lack of income guidelines did allow middle income Ohioans who have been priced out of the market and who voted for this program to finally fulfill the American dream of owning an affordable home. We believe that the final analysis of our program will confirm our preliminary statistics and show that significant numbers of low and middle income people in Ohio were able to take advantage of the lower interest mortgage loans. This is not a program for the wealthy.

Finally, there are those who argue that the interest lost through MRBs is a raid on our Treasury of money that could help reduce the federal deficit—one of the chief culprits of the high interest rates. This misrepresents the impact of MRBs on the deficit.

Eliminating the MRBs would only reduce the deficit slightly. Elimination of the MRBs is another attempt by the Reagan Administration to balance the budget on the backs of the middle income taxpayer—those already carrying the burden of the federal taxes. They have less deductions available to them, especially if they cannot afford a home, and the loss of affordable housing would just be another blow.

Our nation's deficits continue to be caused by out-of-control defense spending and tax cuts financed with borrowed money, not by workable programs such as the mortgage revenue bonds.

I urge adoption of H.R. 1176 and the elimination of the sunset clause of December 31, 1983.

County of Orange,
Santa Ana, Calif., June 10, 1983.

Mr. John Salmon,
Chief Counsel, Committee on Ways and Means, Washington, D.C.

Dear Mr. Salmon: The County of Orange appreciates this opportunity to present written testimony in support of HR 1176 and the repeal of the sunset date for Mortgage Revenue Bonds (MRB's). The County of Orange has been utilizing MRB's since 1980 to address our severe shortage of housing for first-time homebuyers making less than 120 percent of the area median income. The MRB program has greatly assisted the County in stabilizing its tax base and reducing community service and infrastructure costs. These achievements are being realized because the MRB program has helped to stabilize the County's housing industry and has provided housing for the County's workforce to live near where they work. In the development of our housing program, the County has become the largest local government MRB issuer, and has consistently led the way in achievement of more cost-effective MRB utilization. I believe the quality of the County's program will be evident in the following comments as well as the fact that the County's program already substantially mitigates many of the Federal concerns in relation to MRB's.

Before I go into the technical details of our support for HR 1176, I would like to discuss several major issues that have direct impact on Orange County.

1. There are frequent charges that the MRB program does not facilitate the development of additional housing for first-time homebuyers in the appropriate income ranges. In Orange County it can be clearly demonstrated that the MRB program has significantly increased the development of housing for first-time homebuyers with incomes less than 120 percent of the area median income. This can be demonstrated by the following facts: In 1980, as required by the rating agencies for all MRB issues, a demand study for the proposed MRB issue was conducted by an independent consultant. This study indicated that the demand for affordable housing was ten times the projected availability. Each subsequent MRB issue has had a feasibility study providing similar results. Correspondingly, developer demand for funds from each bond issue has routinely been three or four times the amount of allocation available. Yet, for the past three years, virtually the only housing in the relevant price range has been built with MRB financing. While this is somewhat subjective, I feel the overwhelming strength of the unmet demand clearly indicates that housing is being built that otherwise would not be. Sophisticated Orange County developers would not ignore this demand if they could produce housing for this buying group in any other way. As a last point to indicate the demand for this housing, just a few days ago the William Lyon Company opened the first phase of an MRB financed project. There were over 2,000 families vying for the 50 available units with some families camping out at the project for a week.

2. Land use planning is one of the most important local government prerogatives. Assuming there is concurrence that there is a need for housing programs, then it must be recognized that local government must control this planning to recognize local differences and for the most cost-effective development of jurisdictions. The

MRB program is the only Federal program that provides the flexibility necessary for this effectiveness.

3. The cyclical nature of housing development contributes to significant swings in the local and national economies. The MRB program has helped to stabilize the housing market by providing long-term three-year funding commitments that allow developers to plan based on a secure funding source. Further, the guaranteed takeout financing stimulates private construction lending which allows the development to occur.

The County's technical concerns relating to this legislation come from our review to the U.S. General Accounting Office Report to the Chairman, Committee on Finance, United States Senate, titled "The Costs and Benefits of Single Family Mortgage Revenue Bonds: Preliminary Report," dated April 18, 1983.

1. The Report raises several concerns abut the efficiency of MRB's.

a. The Report states that only 87 percent of the funds raised are available for mortgages. Since the enactment of the Ulman legislation, 97 percent of the bond funds in Orange County MRB issues have been available for mortgages. Part of this wide variation is accounted for by the fact that developers are charged 4½ points to participate in the MRB program which becomes an additional source of funds. Otherwise, it appears that the Report relies on outdated structuring approaches that utilized larger reserves.

b. The Report analyzes several program alternatives to MRB's. The analyses conclude that each of the alternatives are more cost efficent than MRB's. One obvious gap in the analyses is that the proposed alternatives do not include any program or administrative costs while MRB programs in Orange County are totally self-supporting.

2. The Report's general lack of understanding about MRB's is most clearly demonstrated by the discussion that indicates call premiums are a substantial cost to MRB's. The County is not aware of any MRB issue that has ever had a bond call at a premium. All calls have been par.

3. The Report shows a substantial difference in the subsidy cost for taxable bonds and tax credits on mortgage grants. County staff has discussed this very significant difference with a number of financial professionals. Based on the information in the report, there is no apparent reason for the difference. The subsidy requirements should be approximately the same for each alternative.

4. The Report's analyses of program alternatives subsidy requirements are based on a 12-year mortgage life. This substantially reduces cost in relation to a 30-year commitment which would be necessary to be equivalent to the subsidy time period provided by MRB's. Staff discussed this point with a number of professionals in the field and it appears very unlikely that lenders would accept a mortgage buydown or subsidy on a commitment limited to 12 years on any large scale.

5. The Report is based on 1982 experience. This is one of the worst times for interest rates in recent history. This limited time period distorts the Report's analyses and conclusions. The Report would be substantially more valuable if it was based on a much broader data base and reflected the current state-of-the-art. MRB structuring has evolved significantly in the last year. Issues structured in 1983 are undoubtedly more cost-effective than those from prior years.

6. Last, the Report conveniently switches back and forth between income levels and percentage of the area median income to support whatever point is being made. This does not recognize regional differences and seriously understates the income penetration of programs. For instance, 20 percent of the County's units financed by the program are required to be priced affordable to families making less than 80 percent of the area median income. This shows the County's high level of commitment to achieving income penetration as this is one of the few if not the only program with this requirement. Yet, this significant achievement is hidden when programs are generalized on a nationwide basis and discussed in terms of income levels rather than recognizing regional differences and discussing programs in terms of area median income.

If there are any questions or points you would care to discuss further, please contact my office at (714) 834-3110.

Sincerely,

Roger R. Stanton,
Chairman, Board of Supervisors.

City of Pekin,
Pekin, Ill., June 14, 1983.

Hon. Dan Rostenkowski,
Chairman, Committee on Ways and Means, Washington, D.C.

Dear Mr. Chairman: I am writing you to express my strong support for Industrial Development Bonds. They are of vital importance of towns and cities across America, especially as we continue our drive for jobs and sustained economic recovery. I ask that this letter be made a part of the permanent hearing record compiled by the House Ways and Means Committee in its June 15, 16, 1983 hearings on tax-exempt financing, specifically H.R. 1635.

When Congressman Jake Pickle introduced H.R. 1635, he stated that the additional restrictions on IDB use in the bill were designed to prevent this kind of tax-exempt financing from forcing municipalities to incur higher interest charges on their traditional municipal borrowings. Aside from the fact that I seriously question the validity of this "crowding out" argument, which I will discuss later, only confusion occurs when the issue is framed as a conflict between traditional municipal financings (presumably a desirable use) and private purpose (presumably nontraditional and undesirable) uses.

You may rest assured that no one in Pekin, Illinois, considered Commonwealth Edison's pollution control financings as private purpose. Nor did anyone consider as narrow, private purpose use (as opposed to a broad public benefit use) facilities expansion and modernization here in Pekin by Garnac Grain Elevator Company, Midwest Solvents, Quaker Oats, AIRCO, and others. These Projects, and others, have always been viewed in our community as benefitting the public generally, because of the positive effects they have on jobs and local revenues.

Mr. Chairman, I believe you would get the same response on this matter of public vs. private use from Mayors in Portland or Biloxi whose communities have benefitted from waterfront facilities improvement; or, from Mayors in Jacksonville or Richmond, whose communities were enhanced by cleaner rivers. Similarly, the Mayors of Reno, Oklahoma City or Rochester would probably feel their airport improvements were public, not private benefits.

Turning to the assertion that IDB's are the driving force behind higher rates for other municipal borrowings, I must say that advancing that argument necessarily presumes that the tail never stops wagging the dog. This is absurd. It is Mr. Chairman, like saying the rate a bank pays its Christmas club participants is the driving force behind what the banks pays its passbook account savers, or its large certificate or deposit customers.

There are, truthfully, too many other known, significant factors that drive interest rates up and down, on both taxable as well as tax-exempt securities, to ascribe so much of the blame to IDB's. I do not believe the historical ratio of tax-exempt to taxable rates can support the crowding out theory, because that ratio was higher in 1969 when an unfavorable Treasury ruling virtually shut down the IDB market, than it was in the Fall of 1982 when new issue IDB volume was very heavy.

As is the case with most other market place opportunities, the demand by investors for particular kinds of investments has immense influence over what the investment will bring, and in the case of tax-exempt securities, what their final price, hence interest rate, will be. For example, banks and non-life insurance companies have historically been large and active purchasers of tax-exempt obligations. However, recent statistics will show their demand for these securities has decreased sharply since 1979. As the profitability of the purchasers declines, they become net sellers of municipal bonds, rather than purchasers, driving up municipal interest rates as tax-exempt bond supply exceeds demand.

There is, in addition, another very interesting and subtle factor at work in the financial markets. Instead of tax-exempt rates rising faster than taxable rates, increasing the ratio as some say, the tax-exempt/taxable rate spread has recently been affected by declining taxable rates as more and more purchasers of taxable securities are tax-exempt institutions. These institutions include the Federal Government, pension funds, state and local governments and foreign governments.

Tax-exempt entities purchasing taxable bonds do not need to demand as high an interest rate as do taxable purchasers, since no part of the interest payment is reduced by taxes. Thus, taxable bond rates drift lower as an increasing proportion of taxable bonds are purchased by tax-exempt entities. Consequently, tax-exempt interest rates may appear to rise relative to taxable rates, when what is really happening is that taxable rates are falling toward tax-exempt rates, for reasons totally unrelated to the tax-exempt market, or to IDB's, for that matter.

It is abundantly clear to me, Mr. Chairman, that projects financed with IDB's return revenues to the Treasury and create permanent, productive jobs for our communities and our nation. Obviously, what the nation needs is jobs in order to increase our tax base to generate the revenues needed to help narrow the deficit. That, I believe, should be our overriding concern. It will be counterproductive, I believe, if the Congress enacts additional restrictions such as those contained in H.R. 1635. Only ten months ago significant restrictions were placed on IDB's and I suggest the Congress let these changes have a chance to work. Many of the most notorious, objectionable uses of IDB's were prohibited last year. I respectfully suggest, Mr. Chairman, that we not saddle this important jobs creating program with further burdens that would destroy its utility for communities like ours, and others across Illinois and the rest of the country.

Sincerely,

WILLARD E. BIRKMEIER,
Mayor, Pekin, Ill.

STATEMENT OF JOSEPH P. THOMAS, EXECUTIVE VICE PRESIDENT, THE PEOPLES GAS LIGHT & COKE CO., CHICAGO, ILL.

The Peoples Gas Light & Coke Company is filing these comments with the House Ways and Means Committee to insure that the Committee recognizes that the benefits flowing from industrial development bond financing by gas distribution companies enure directly to our ratepayers, and therefore, these benefits should be preserved.

The Peoples Gas Light & Coke Company is a gas distribution company serving the City of Chicago. It has approximately 867,000 customers which include 822,000 residential customers. The Company is very aware of the increasing cost burden that is borne by our customers due to rising gas costs. As a result the Company has been very active in undertaking actions to control gas costs which include taking a very active role in working on NGPA legislative proposals in an attempt to minimize gas costs.

One method that the Company has used to reduce costs was through the use of industrial development bond financing for its Synthetic Natural Gas Plant in Joliet. The Company raised approximately $100 million through a series of bond issues from 1973 through 1975 at interest rates ranging from 4⅞ to 7⅛ percent when comparable conventional debt financing would have been at rates ranging from 7.5 percent to 9.7 percent. Using this differential, the financing cost savings resulting from the use of industrial development bonds was approximately $25,000,000. Furthermore, we are planning to refinance these facilities commencing this year through the use of industrial development bonds. On the basis of current interest rate differentials between industrial development bonds and comparable conventional debt financing, we anticipate an approximate savings of $30,000,000 in interest costs over an anticipated ten year period for this refinancing. In addition, we have been reviewing the possibility of using industrial development bond financing for facilities in the City of Chicago that are included in our normal capital budget for the next three years. If we are able the finance under this method, we currently estimate that we may be able to finance those facilities at interest rates in the range of three percentage points less than for comparable conventional debt financing.

The key point that we wish to emphasize to the members of this Committee is that the beneficiary of this savings in financing costs is the gas consumer. For the most part, our residential consumers in the City of Chicago are middle to low income people and utility costs represent a substantial burden for many of them. Therefore, we strongly feel that industrial development bond financing for facilities used for the local furnishing of gas should be maintained for their benefit. The above recited savings in interest costs for the SNG plant financing is a direct benefit to our customers since the embedded debt cost reflected in our rates is reduced to reflect such lower interest rates.

If we are able to finance our capital construction program through industrial development bonds, this will result in an even larger interest cost savings for our customers over conventional financing due to the greater capital cost involved in such program than in the SNG plant. However, TEFRA has already substantially reduced the benefits of these interest cost savings for new projects by requiring the use of the straight line method of recovery of capital cost rather than the use of the Accelerated Cost Recovery System for property financed by Industrial Development Bonds. This prohibition results in a substantial offset in interest costs savings to our customers because of the increased costs reflected in our rates that result from the use of a longer recovery period for captial investment. H.R. 1635 provides that the recovery period would be extended over an even longer period. For example, the recovery period for 15 year life utility property would be extended to 22 years. We strongly oppose the extension of any such periods because such extension would further reduce the attractiveness of such financing by requiring a longer recovery life for our capital investment and therefore result in increased cost for our consumers. Because of the limitations of the two county rule for the local furnishing of gas, the use of these bonds is basically limited to certain major metropolitan areas. These areas tend to have a higher percentage of lower income people than other areas so in our opinion this is a good reason for continuing the industrial development bond funding program for gas utilities without making further inroads on its benefits.

We recognize the Congress is concerned about the need to raise additional revenues because of pending deficits. However, we do not feel that reducing the benefits of industrial development bond financing at the expense of our consumers is an appropriate vehicle for raising additional revenue.

STATEMENT OF JAMES F. MCMANUS, SENIOR VICE PRESIDENT, PHILADELPHIA INDUSTRIAL DEVELOPMENT CORP.

Mr. Chairman and Members of the Committee: My name is James McManus and I am a Senior Vice President of the Philadelphia Industrial Development Corporation.

I am speaking today in opposition to House Bill #1635, which places further restrictions on the use of Industrial Development Bonds.

The Philadelphia Industrial Development Corporation (PIDC), through its affiliate organization, known as the Philadelphia Authority for Industrial Development (PAID), serves as the issuing Authority for all tax-exempt industrial development bonds and mortgages within the City and County of Philadelphia. Since the inception of the program, PIDC has participated in financing projects involving over $1 billion of tax-exempt funds which have been part of total project costs of approximately $1.7 billion. More importantly, this financing enabled us to retain and create 188,000 jobs in Philadelphia.

The critical role of this country's small businesses in creating new jobs has received much recent recognition from both the Congress and the Administration. A recent analysis of our agency's clients, who have been assisted with IDB financing, indicates that 80 percent of the transactions have been for loss than $1 million, with an average tax-free issue amount of approximately $290,000. These firms represent the economic back-bone of our City and would, in all likelihood, not have completed their projects without the additional incentive of low-interest, tax-exempt financing. Tax-exempt financing has benefitted and continues to benefit the smaller inner-city businesses in Philadelphia. These businesses are typically not "footloose" and able to relocate readily. If they cannot finance their capital expansion programs at reasonable interest rates, they will either not grow and expand or they will close down.

The Philadelphia Industrial Development Corporation offers a series of second mortgage programs to help industrial companies expand. The money is offered through the City's Community Development Block Grant Program allocation from HUD. Through this program, PIDC has lent out over $15 million on a revolving loan basis. Second mortgage financing is, in most cases, coupled with a tax-exempt first mortgage to provide an attractive financing plan. The limited amount of second mortgage money must be spread out over many deserving companies and the tax-exempt financing is critical to the success of these industrial recipients.

The accelerating loss of business investment in older Northeastern cities has been well documented by the business press. In the last ten years, Philadelphia alone has lost a total of 87,000 manufacturing jobs, with an estimated total loss of 243,600 jobs when the economic "ripple effects" are considered. While it is impossible to state what the situation would have been if IDB financing were less attractive, we are fearful that a large number of the 188,000 jobs retained and created by our agency's tax-exempt financing program would have been lost.

Specific provisions of H.R. 1635 which concern us include the exclusion of land acquisition as an eligible tax-exempt financed activity, the extension of the recovery period for depreciable assets, the limiting of joint IDB financing and ACRS recovery to only low-income housing projects, and the limiting of eligible IDB beneficiaries to firms spending no more than $20 million on all capital expenditures which would severely restrict our flexibility in assisting larger firms with great employment potential. Moreover, we would like to see the current sunset date removed from the law.

Philadelphia has not been immune to the current economic problems which have created a lag in capital spending throughout the United States. To further restrict

IDB financing at a time when business confidence is weak, will certainly delay local expansion projects which have been placed on the "back burner" until economic conditions are more propitious. Philadelphia needs local business expansion and investment to help reduce a current inner-city unemployment rate of over 30 percent. The enactment of House Bill 1635 will have a direct and detrimental impact on our City's efforts to retain existing employment and create an atmosphere conducive to the expansion of new job opportunities.

I urge this Committee and the full Congress to reject any tax law changes that would impede local economic development efforts.

STATEMENT OF ROGERS CONSTRUCTION CO., LEVELLAND, TEX.

INTRODUCTION

We wish to express our appreciation to the members of the Ways and Means Committee for the opportunity to testify concerning Industrial Development Bonds. We would also like to give a special thank you to Representative Hance for all the help he has given us in this matter and all other matters.

In reference to the Bond issue, be advised that Industrial Development Bonds are an important development mechanism in West Texas. It has and can continue to be the tool used in the diversification goal set by communities in West Texas and the remainder of the country. They can also be an important tool to promote integration of low income persons with upper income levels. Bonds can also be very important to rural communities which are predominately dependent on primary industries such as agriculture and oil. This is not the first time nor will it be the last that the oil industry and the agricultural indusrty have seen a slump, simultaneously. To prevent a community from being in a boom or bust situation, diversification is necessary. In order to meet the goal of diversification, interest rates must be at levels where manufacturing and the service sector can service debt for new development.

Communities on the South Plains of Texas can not rely on enticement programs to encourage manufacturing firms from other areas of the country to move into the South Plains. It is more realistic for home grown and existing industries to expand and develop. One way to encourage such expansion and development is through tax incentives directed at the private sector. The Industrial Development Bond program does exactly that.

JOB CREATION

The present Administration has been urging the American people to decrease the involvement of the Federal Government in programs to provide needed services such as job creation and housing for the poor. To encourage the private sector to take on these responsibilities tax incentives should be used. The Industrial Development Bond program is a tax incentive program whereby investors are encouraged to participate in lower interest loans for developments that create jobs and provide low income housing.

There are several examples where this incentive program has worked. The City of Seminole, Texas is a case in point. In the last several years the only development that has occurred in the City of Seminole has been through the use Industrial Development Bonds. The lending institutions in Seminole, due to a tremendous slow down in the oil industry and the agricultural sector, have been unable to loan monies for capital. The Industrial Development Bond program has allowed the City of Seminole to seek capital investors from outside the region. The result has been growth, both fiscally and physically.

We believe that the Industrial Development Bond program is cost efficient. In addition to the theory that jobs created through the multiplier effect make the Industrial Development Bond program efficient, we believe it is an efficient program standing on its direct benefits. The following comparison illustrates this point.

A comparison of the hard costs of Industrial Development Bonds in their worst scenario to the costs of direct federal programs that provide similar services will show that Industrial Development Bonds are efficient:

A motel in Denver City was built with Industrial Development Bonds for $600,000 at 80 percent of the prime rate amortized over 15 years. If we assume the 10 percent interest rate which is higher than the present prime rate and a 50 percent tax bracket for the purchaser, the foregone tax dollars to the government over the 15 year period is $280,286. This translates to $1,868.58 per job per year with the creation of 10 new jobs.

The federal employment and training program that is charged with job placement and training in the South Plains Region claims to provide jobs at a cost of $2,865.47 [1] per job. We believe the South Plains Region is considerably more efficient than other employment and training programs and yet it is more efficient to provide jobs through the Industrial Development Bond program than the federal employment and training program. The Industrial Development Bond program viewed as a jobs program is very efficient.

LOW-INCOME HOUSING

The Industrial Development Bond program is also efficient as a provider of decent, safe, and sanitary housing for low and moderate income persons. The following is a comparison of the cost to the government for grants to Housing Authorities and cost to the government because of foregone tax dollars through the Industrial Development Bond program:

The Hockley County Housing Authority has just received a grant for $600,000 plus administrative costs to provide a 20 unit housing complex for low and moderate income persons in Hockley County.[2] The cost per unit is approximately $30,000 plus administrative costs.

In comparison, Hockley County has just approved an Industrial Development Bond for $650,000 at an interest rate of 11 percent for 15 years for the construction of a 26-unit housing complex. The foregone tax to the government over the 15 year period assuming a 50 percent tax bracket for the purchaser is $339,909. Therefore the cost per unit to the government through foregone tax is $13,073.

The Industrial Development Bond program as a low income housing provider is very efficient as can be seen by the above comparison.

THE INDUSTRIAL DEVELOPMENT BOND LIMITATION ACT

Support of a program that can provide needed services through tax incentives carried out by the private sector is the direction this country should be headed. President Reagan has asked the American people to support programs sponsored by the private sector to replace government subsidized programs. One sure way to get the private sector involved in historically public programs is to offer a tax incentive. It seems to us that the Industrial Development Bond program does exactly that.

Therefore, we urge you to support Industrial Development Bonds. Included in your support of Industrial Development Bonds are we ask that:

(1) You accept the repeal of the Sunset provision of the Mortgage Subsidy Bond Tax Act of 1980;

(2) You not accept the extended depreciation provisions outlined in Section 1(B)(i) of HR 1635; we believe that cumbersome accounting procedures will be the only outcome of such a provision;

(3) You not accept the limitations on large businesses; as a provider of jobs, large businesses are a necessary entity in all parts of the country; competition and a good mix of industry is necessary;

(4) You not accept the $20 million limitation to any one person at any one time; when a program is as efficient as the Industrial Development Bond program in creating jobs and providing housing to low income individuals, it should not be limited; and

(5) You not accept the elimination of land from allowable purchases; in most cases the land is required as collateral in a first lien on any project involving real estate; small business must be able to provide to the purchaser of bonds a lien on land without encumbrances; if land cannot be purchased with bond proceeds, the mortgagor loaning funds for the purchase of land will hold the first lien.

Finally, we urge your support of the Industrial Development Bond Program in all other ways.

Again we wish to express our appreciation for the opportunity to have our voice heard. Thank you.

STATEMENT OF THE CITY OF SAN DIEGO

The City of San Diego ("San Diego") is a charter city in the State of California with approximately 921,000 residents and covering an area of 394 square miles.

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[1] This information was provided by South Plains Association of Government. Annual Report—fiscal year 1982, Lubbock, Tex.

[2] This information was provided by Hockley County Housing Authority, Levelland, Tex.

San Diego wishes to express its support for industrial development bonds financing ("IDB") for the local furnishing of gas and electricity. San Diego believes this form of financing is beneficial to citizens in our area as it enables the utility servicing our region, San Diego Gas & Electric Company, ("SDG&E") to raise capital for improvements at a reasonable cost. The financing through IDBs will directly benefit the consumers in the area because they will not have to bear the additional financing costs associated with conventional financing in their electric and gas rates.

San Diego supports IDB financing as a means to promote economic development in those areas where it is most needed and in the local furnishing of gas and electricity. The residents of San Diego are presently experiencing some of the highest gas and electric rates in the nation. IDB financing provides a lower debt cost to the utility and can be expected to reduce these utility rates.

In order to avail itself of the opportunity to issue IDBs, San Diego adopted an ordinance in September, 1981 authorizing and establishing a procedure for the sale and issuance of revenue bonds or other evidences of indebtedness for the purpose of providing financing to participating parties for economic development purposes. Further, a resolution was adopted in September 1981 and March 1983, which gave approval for the issuance of such bonds to fund a loan to SDG&E to finance the acquisition and construction of generation and transmission facilities for electric energy and local distribution facilities for electric energy and gas. SDG&E has assured San Diego providing tax-exempt financing for the aforementioned project will be passed on to their electric and gas customers, including all such customers within the boundary of the City, by-way-of lower rates than would otherwise prevail.

Therefore, San Diego has authorized the issuance of revenue bonds in a aggregate principal amount not to exceed $300 million in one or more series as SDG&E and San Diego's officers may determine are appropriate. Pursuant to federal legislation and city ordinances, a loan agreement between San Diego and SDG&E will be executed covering the terms and conditions of the issuance of the bonds.

It is San Diego's position that federal legislation which would prohibit, restrict or reduce the benefits to the public at large of the local furnishing of electricity and gas exception to the IDB financing legislation would be detrimental to the public interest of the citizens of the City of San Diego. Further changes in the tax law which would reduce the benefits of IDB financing for furnishing of local services, would not be in the public interest.

Statement of Nicole A. Clay, Director, San Diego Energy Recovery Office, County of San Diego, Calif.

In reviewing the current status and use of Industrial Development Bonds (IDB's), the importance of IDB financing and current tax benefits cannot be overemphasized when considering the growth and development of solid waste-to-energy facilities.

The Administration Tax Proposal, as originally drafted last year, would have had a detrimental effect on the financing and construction of new solid waste-to-energy facilities as an economically sound alternative to landfilling. That proposal would have eliminated the use of the Accelerated Cost Recovery System (ACRS) for depreciating plant assets for facilities financed by tax-exempt IDB's and placed in service after December 31, 1982. The ACRS method of depreciation would have only been available to facilities financed by taxable bonds.

The loss of either tax-exempt IDB financing or accelerated depreciation would have adversely impacted the ability of private industry to finance, construct, and operate a solid waste-to-energy facility. Both of these benefits are necessary in encouraging private investments in a public purpose facility which conserves energy by producing electricity from the disposal of solid waste. Without these benefits, it is difficult for solid waste-to-energy facilities to compete for investment dollars because their revenues are fixed by the prevailing price of the fuel displaced by their energy and by the existing cost of landfilling as the disposal alternative.

There is often a narrow margin between economic incentive and economic disincentive for solid waste-to-energy projects. A solid waste-to-energy facility must be able to compete in both the local solid waste disposal marketplace and the energy marketplace. The project must be able to offer waste disposal fees which are competitive with landfilling and to offer prices for energy which are no more than the cost to the energy buyer of the fuel displaced.

Generally, solid waste-to-energy facilities will not be considered economically feasible unless debt service and operating costs are minimized by (1) issing tax exempt, lower interest Industrial Development Bonds in financing long-term debt; (2) attracting private equity to reduce the amount of debt which must be sold; and (3) depreciating facility assets under the Accelerated Cost Recovery System (ACRS).

A contribution of private equity to a solid waste-to-energy project reduces the total amount of capital that must be debt-financed, thereby reducing the project's annual debt service. The return required by the equity investor is realized through the available tax benefits. The elimination of the ACRS accelerated method of depreciation, when IDB financing is used, would result in a lower return to the investor by lowering tax benefits. This would result in a reduction in the amount of upfront equity contribution offered by the investor.

The proposal last year to limit tax benefits for privately financed public purpose facilities was based on the premise that the ACRS method of depreciation enacted in 1981 under the Economic Recovery Tax Act provided such a significant additional benefit for attracting private capital that the additional benefit of tax-exempt financing was not needed. For solid waste-to-energy facilities, the economics are such that the loss of either IDB financing or ACRS depreciation could yield and increase in debt service and disposal costs which would render the project not feasible. The Tax Equity and Fiscal Responsibility Act of 1982 which was finally enacted recognized this fact.

Although the Tax Equity and Fiscal Responsibility Act of 1982 states that facilities financed by IDB's and placed in service after December 31, 1982 must use the straight line method of depreciation instead of the ACRS method, there were, however, five exceptions to this rule. Solid waste disposal facilties were one of the exceptions and for these facilities both tax-exempt, IDB financing and the ACRS method of asset depreciation were retained.

Unfortunately, the tax benefits retained for solid waste-to-energy facilities are now threatened by HR 1635, the Industrial Development Bond Limitation Act. HR 1635, as currently written, would have a serious negative impact on the San Diego Energy Recovery (SANDER) Project and all other waste-to-energy projects for which Industrial Development Bonds (IDB's) have not been issued as of the effective date of the bill. HR 1635 would remove the tax benefit of ACRS, or accelerated depreciation, for all projects financed by IDB's, except for residential rental projects unless the IDB's are issued before enactment of the bill.

Your consideration is urged in retaining the tax benefit of accelerated depreciation for solid waste and sewage disposal projects financed by IDB's and in retaining this tax benefit for all other currently qualifying projects for which significant costs have been incurred or for which the governing body of the project has taken official action related to the issuance of IDB's.

Statesboro & Bulloch County Development Authority,
Statesboro, Ga., June 14, 1983.

Hon. John J. Salmon,
Chief Counsel, Committee on Ways and Means, Washington, D.C.

Dear Mr. Salmon: Please accept this letter as our written testimony relative to the important matter of Industrial Development Revenue Bonds.

The United States has a long history of being developed through the risks taken by small, enterprising businesses. The industrial development bond financing procedure has provided a means through which many small industries have been able to expand and become stable components of local economies. It is my opinion that the industrial development bond program needs to be retained as the tax exempt financing provides great incentive for small industries to continue taking risks in order to compete in a growing market.

It is especially important in my view, that the present law allowing private placement without going through the costly bond registration procedure, be retained. There are many small industries which have been able to get started and to grow by tax exempt revenue bond financing in amounts under $500,000. It is my understanding that registered bond issue costs dictate that a minimum issue be somewhere in the neighborhood of $2 million before it can be economically worthwhile. There is a big gap between $2 million and $100 million, and there are many small industries which have benefitted and will continue to benefit through the small issues of $100 million and up.

In order to protect the integrity of the industrial development bond program, the local Statesboro-Bulloch County Development Authority has been very careful to limit the issuance of financing, either bond or private placement, to those facilities which are industrial in nature. The Authority has not financed retail and service establishments.

Please consider the need to retain attractive, incentive financing for small industries, as well as major industries, for communities which need economic diversification through industrial development. The preservation of the industrial development bond program will achieve quality economic growth for local communities, providing jobs for citizens and expanding the quality of life for citizens. Without incentive type financing, the economic strength of local communities and the nation as a whole will suffer.

Thank you for your consideration of the above.

Sincerely,

JOE P. JOHNSTON,
Chairman.

UNITED STATES LEAGUE OF SAVINGS INSTITUTIONS,
Washington, D.C., June 17, 1983.

Mr. JOHN J. SALMON,
Chief Counsel, Committee on Ways and Means, Washington, D.C.

DEAR MR. SALMON: The U.S. League of Savings Institutions is pleased to comment on H.R. 1176, the Housing Finance Opportunity Act of 1983, as it relates to the elimination of the sunset provision for tax exempt mortgage revenue bonds. We will also comment briefly on a related bill, H.R. 1635, regarding the treatment of tax-exempt bonds secured by federally insured certificates of deposit.

The U.S. League of Savings Institutions believes that tax-exempt mortgage revenue bonds may well have a place in the housing finance system, but that the unrestricted use of such bonds is deleterious to overall health and vitality of homeownership in America.

The popularity of mortgage revenue bonds in recent years is indicative of the need for housing in this country and the strong desire for homeownership. Yet at the same time, the unrestricted use of mortgage revenue bonds obscures some of the deeper problems afflicting the housing delivery system and thereby delays progress in effecting the necessary reforms.

In elaborating on this point, our comments will address four main areas which relate directly and indirectly to these deeper problems. On this basis of these comments, we will then offer suggestions regarding means of restricting the issuance of mortgage revenue bonds for the Subcommittee's consideration.

Mortgage Revenue Bonds and Affordability: The housing sector is now recovering from its worst recession in the postwar period. The primary reason for this deep recession was the inability of large numbers of home buyers to afford the monthly mortgage payments on new and existing homes offered for sale.

Although three elements interact to determine affordability—income, mortgage interest rate, and home price—it has become traditional to associate affordability problems with "high" interest rates. Mortgage revenue bonds seek to alleviate these problems by providing mortgage financing at lower, tax-exempt rates.

Incomes and home prices are just as important in determining affordability as interest rates, but unrestricted mortgage revenue bond financing does little, if anything, to deal with these aspects of affordability.

State and local governments do, however, have within their power the ability to reduce the regulatory costs of housing construction—permit processing, zoning, codes and standards. The Joint Venture for Affordable Housing, under the auspices of the Department of Housing and Urban Development, has made great strides in reducing such costs in collaboration with some state and local government agencies. The Department of Housing and Urban Development, of course, must rely on the voluntary participation of state and local governments to carry this program forward.

As one among several ways of restricting the issuance of mortgage revenue bonds, the Committee might therefore wish to consider making their issuance conditional upon participation in the Joint Venture for Affordable Housing. Such a condition should have the effect of assuring that state and local governments are taking affirmative action to reduce the regulatory costs of construction and home prices in their jurisdictions before resorting to the issuance of mortgage revenue bonds.

Mortgage Revenue Bonds and Employment: Advocates of mortgage revenue bonds frequently note that they serve to stimulate employment in the construction industry and thereby in the community at large. There is clearly merit to this argument—to the extent that mortgage revenue bond financing induces new construction that would not have occurred otherwise and to the extent that the funds so raised are used to finance new construction rather than the purchase of existing homes.

Thus, the Committee might wish to consider restricting the use of the proceeds of mortgage revenue bonds to the financing of new housing units.

Mortgage Revenue Bonds and Federal Deficits: The current projections of the budget deficits of the federal government are a significant cause for concern. These deficits threaten higher borrowing costs for the entire economy in the months ahead. Slower economic growth rates, smaller increases in family income and employment, and fewer housing starts and sales are the inevitable consequences of higher interest rates.

Although arguments can be made on both sides of the question of the tax efficiency of mortgage revenue bonds, a recent study of the General Accounting Office contends that mortgage revenue bonds are ineffective in generating net additional housing starts and that mortgage revenue bonds are the most expensive (to the Treasury) of several mortgage subsidy programs analyzed. If this analysis is correct, the income and employment effect benefits attributed to mortgage revenue bonds are negated, but the tax expenditure cost to the Treasury remains.

Under these circumstances, home buyers in general and the housing sector as a whole would be less well off than if no mortgage revenue bonds were issued.

Other aspects of the inefficiency, inequity, and crowding-out implications of mortgage revenue bonds were presented by the U.S. League to your Committee on Ways and Means in testimony May 15, 1979.

Mortgage Revenue Bonds and the Housing Finance System: For a variety of reasons, not the least of which is the general deregulation of the financial sector, the housing finance system must move in the direction of adjustable-rate mortgage lending. Even more than the administrative pricing of FHA/VA fixed-rate mortgage loans, mortgage revenue bonds retard progress in this direction by offering subsidized, below-market interest rates on long-term fixed-rate mortgages.

Adjustable-rate mortgages can and must be offered at interest rates below those available for fixed-rate loans to compensate the borrower for sharing the interest rate risk with the lender. The presence of below-market fixed-rate mortgages funded by mortgage revenue bonds thwarts the effort to introduce adjustable-rate mortgages.

H.R. 1635, Prohibiting Federally-insured Industrial Development Bonds: For similar reasons, the U.S. League supports H.R. 1635, as it applies to tax-exempt industrial development bonds issued after April 14, 1983 which are directly or indirectly insured by the FDIC and FSLIC. However, in the interests of extending access of the housing finance system to the capital market and of introducing longer-term (e.g. five-year) adjustable-rate liability products which match adjustable-rate loans, the U.S. League urges the Committee to exercise great care to assure that the provisions of H.R. 1635 not be extended to taxable bonds.

The U.S. League thanks the Committee for the opportunity to comment on these two items of pending legislation.

Sincerely,

Roy G. Green,
Executive Vice President.

Phil Gasteyer,
Legislative Counsel.

Dr. James W. Christian,
Chief Economist.

Virginia Association of Housing &
Community Development Officials,
June 9, 1983.

Mr. John J. Salmon,
Chief Counsel, Committee on Ways and Means, Washington, D.C.

Dear Mr. Salmon: The Virginia Association of Housing and Community Development Officials strongly urges your support of legislation to repeal the "sunset provision" of the Mortgage Subsidy Bond Tax Act.

At a time when housing programs to aid low and moderate income families and redevelop blighted areas are so severely curtailed, it is essential to maintain mortgage revenue bonds (MRB's) as one of our few remaining housing tools. What tax loss may occur in the targeted use of MRB's is a minimal cost for the housing produced or rehabilitated. Moreover, the use of MRB's in our programs represents a type of financing that is necessary to make a particular project work. Much of what we accomplish with MRB's could never come about with taxable financing, a point which we feel nullifies the tax loss concern. To a great degree, the same holds true with our targeted use of tax-exempt industrial development bonds (IDB's) for redevelopment purposes. The notion of repealing the MRB sunset provision at the expense of IDB's is, in our opinion, a very poor trade-off.

Special mention of housing rehabilitation through MRB's is necessary as this is an overlooked, yet extremely valuable, aspect of the program. Many of our localities have developed privately financed, tax-exempt rehabilitation programs with great success. This is an area of need, especially with respect to low and moderate income persons, which needs MRB's and will not be adequately served otherwise.

We ask that you take these brief points into consideration as the sunset provision repeal is deliberated. Again, MRB's are an important public redevelopment and housing program resource in a time when there are few.

Sincerely,

NEVA J. SMITH,
President.

STATEMENT OF JAMES T. FLYNN, LIEUTENANT GOVERNOR AND SECRETARY, WISCONSIN DEPARTMENT OF DEVELOPMENT

I am pleased to have the opportunity to present this statement on H.R. 1176 and on H.R. 1635.

I am Lieutenant Governor of the State of Wisconsin and also serve as Secretary of the Wisconsin Department of Development (DOD). The Department of Development is the primary state-level agency in Wisconsin with responsibility for economic and community development and for housing.

I wish to take note of Chairman Rostenkowski's statement that "As long as interest subsidies paid for by the Federal government can be given out without any direct cost being borne by the issuing government, there is little or no reason for IDBs to be issued with restraint or with some sense of public purpose priorities." I freely acknowledge the cost to the federal treasury and the abuses that have occurred in many but not all places. However, there are benefits as well as costs; there also has been substantial development. The Wisconsin experience both with Mortgage Revenue Bonds and with Industrial Development Bonds illustrate the "plus side" of these two programs.

These positive achievements render talk of a "trade" of Mortgage Revenue Bonds for Industrial Development Bonds meaningless. Both of these programs work and work well in Wisconsin; both create jobs; both (ultimately) result in more, not less, revenue for the federal and state treasuries. I therefore urge the Committee to support H.R. 1176 removing the "sunset" on Mortgage Revenue Bonds, to reject parts of H.R. 1635 restricting the use of Industrial Development Bonds, or to amend H.R. 1635 to follow the workable model found in Wisconsin law.

The State of Wisconsin, through the Department of Development and the Wisconsin Housing Finance Authority, has offered loans for housing rehabilitation to low- and moderate-income homeowners since 1979, and loans for home purchase since 1982. Those programs, to date, have made it possible for 5,200 homeowners to undertake badly-needed repairs and improvements on over 5,600 housing units and for 3,000 homebuyers, almost entirely first-time homebuyers, to achieve affordable homeownership. The average income of borrowers in our housing rehabilitation program is $17,500 and in the home purchase program is $23,500. The typical home we rehabilitate is over 50 years old. One in every four homebuyers in our program has income below $20,000 and one in ten is below $16,000 income. The average purchase price of homes financed has been $40,350.

In short, Wisconsin has made use of tax-exempt bonds for owner-occupied housing in an effective and responsible way. Our housing rehabilitation program, in fact, achieved a higher level of "targeting" to neighborhoods in need of reinvestment than the Federal law requires and began doing that 18 months before the Mortgage Subsidy Bond Tax Act was passed. Wisconsin has not simply relied on the subsidy provided by tax-exempt bonds. Four and a half million dollars was appropriated from state tax dollars to make deferred payment loans as part of the housing rehabilitation program and over $6 million was appropriated for interest subsidies on installment loans for rehabilitation. The State's Housing Finance Authority has committed over $8 million from its surplus in conjunction with the home purchase loans. We are proud of our record, and we want the opportunity to continue to expand housing opportunities for Wisconsin people through the use of tax-exempt mortgage bonds.

In our view, the bond volume limits and other targeting provision of the Mortgage Subsidy Bond Tax Act are more than adequate to protect the public interest and to create a reasonable control on the Federal financial commitment to an important housing program resource. We believe firmly that commitment should stay in place. Totally eliminating this valuable tool for state and local action to stimulate homeownership and neighborhood revitalization would be a serious mistake.

In addition, the State of Wisconsin has exercised considerable restraint in authorizing eligibility for projects financed by Industrial Development Bonds. As a consequence, existing Wisconsin law is more restrictive than the federal law. In addition, the use of Industrial Development Bonds as a business financing tool has focused on "small" businesses in Wisconsin. According to a recent survey by the Wisconsin Department of Development, 81 percent of the firms for which the Industrial Development Bonds have been issued in the state employ less than 250 employees, with 47 percent having fewer than 50 employees. This business development technique has resulted in the creation of more than 18,300 jobs since the inception of the program ten years ago. Small businesses generally are not simply relocated from one state to another or from one area to another. They are started at the initative of entrepreneurs. In sum, state law allows the following projects for IDBs:

1. Assembling, fabricating, manufacturing, mixing or processing facilities for any products of agriculture, forestry or mining or manufacture.
2. Generating, manufacturing, transmission or distributing facilities for electric energy, gas or water.
3. Telephone and telegraph facilities.
4. Sewage, solid and liquid waste disposal facilities.
5. Printing facilities.
6. Hospital, clinic or nursing home facilities.
7. Industrial park facilities.
8. Dock, wharf, airport or mass transit facilities.
9. Recreational facilities, convention center and trade centers, as well as hotels, motels and marinas related facilities.
10. Facilities to provide certain service activities.
11. Facilities to comply with safety and health rules issued by lawful order of the U.S. Occupational Safety and Health Administration or any similar governmental agency.
12. Warehouse facilities.
13. Facilities in compliance with laws on use of land under lawful order of applicable state or federal agency.
14. Shopping centers, office buildings, convention or trade centers, motels, hotels or other non-residential facilities in blighted areas or in accordance with urban renewal or redevelopment plans.
15. Alcohol fuel production facilities.
16. Cable television facilities which provide certain services only in municipality having a populatin of 2,500 or less.
17. National or regional headquarter facilities.
18. Pollution control facilities.
19. Sewage and solid and liquid waste disposal facilities.

The Department of Development if preparing additional restrictions to Wisconsin's IDB law: Our proposal would redefine eligible manufacturing facilities to include only those facilities specified under Division D of the Standard Industrial Classification Manual. We also would completely remove recreational facilities from the list of eligible projects. We also propose a public approval requirement in our proposal that is more restrictive than the federal requirement. Our proposal requires a public hearing prior to the adoption of the initial resolution and a public notice of the adoption of the initial resolution prior to issuance of the bonds. Federal law requires that each bond issue be approved by the local governing body following a public hearing. I believe that Wisconsin's "hands on" experience should commend these types of restrictions to you, rather than those in H.R. 1635.

Even Wisconsin's new proposals for use of Industrial Development Bonds exhibit similar restraint. The Wisconsin Legislature presently is considering legislation, 1983 Assembly Bill 411, which will create a new mechanism to finance economic development activities in the State. The central purpose is to increase the supply of long-term fixed-rate capital to small- and medium-sized businesses in Wisconsin through the issuance of bonds. The adoption of this proposal will promote the diversification, growth and market expansion possibilities for Wisconsin businesses and, thus, strengthen as well as revitalikze the State's economy. H.R. 1635 would be a serious obstacle to the successful implementation of Wisconsin's efforts to revitalize its economy—an economy that has been hard hit by the prolonged recession and that has experienced a change in the structure of its capital markets.

The following provisions of H.R. 1635, in particular, are likely to affect the Wisconsin initiative adversely. First, the restrictions on the use of "small issue" Industrial Development Bonds to those firms, including their subsidiaries, with total capital expenditures of less than $20 million during the three-year period prior to issuance could exclude the firms targeted for assistance by the Wisconsin initiative. The small and growing companies, which do not have ample equity resources and which lack access to the national capital markets, need a source of long-term fixed-rate capital to finance their building, construction and machinery and equipment requirements. For an expanding firm in a capital-intensive industry, the $20 million figure is very limiting. In addition, the application of this provision to subsidiaries is likely to be detrimental to Wisconsin efforts to promote business creation and expansion. In recent years, many small but sound Wisconsin companies have been purchased by out-of-state firms. During a period of rapidly changing markets, rising energy costs and population shifts, the decision to expand an existing Wisconsin operation or to locate a new operation in the state as opposed to other geographical areas of the nation or abroad, other factors being equal, often turns on the availability of a source of relatively low-cost, long-term, fixed-rate financing. Second, the restriction on the use of "small issue" proceeds to acquire land is likely to deter investment by Wisconsin firms in new plants or branch plants, for which the acquisition of land may be crucial. It also may deter investmnent by out-of-state firms, which may view Wisconsin as an attractive investment for a branch operation, but which, other factors being equal, will choose a location that offers lower land costs.

In conclusion, I wish to emphasize:

1. These are not only revenue laws under consideration, they are important tools for economic development, housing and neighborhood revitalization. Wisconsin has been hard hit by the current recession. I am in the process of formulating a State Development Strategy and have just completed work on a comprehensive State Housing Plan. Wisconsin will need development tools to "retool" its economy and to provide affordable housing. This is a critical time. Denying us tools in a time of change could be disastrous for my state and for the region. In addition, I urge the Committee to remember that the revenues from a revitalized economy and from a strong housing stock can compensate for any (apparent) short-term loss to the Treasury.

2. Wisconsin's current and proposed uses of these development tools are carefully targetted for sound public purposes. Our mortgage programs are restricted to low: and moderate-income households. Our Industrial Revenue Bond law prohibits use for projects that would encourage sprawl. The entire emphasis is on job creation. It would be a serious mistake to undercut sound development because of the abuse of a few.

3. Federal aids to states and localities have borne almost two-thirds of the recent federal budget cuts. Meanwhile, in Wisconsin, the State has become the major source of local revenue. Eliminating these remaining federal incentives will only compound our problems and make a mockery of Wisconsin's long and proud record of helping itself.

Wisconsin could continue to operate effectively within existing mortgage bond restrictions and within the existing ceiling on the size of the issue. Wisconsin also could undertake progressive development if the prohibition of purchase of insured instruments found in H.R. 1635 were retained. The new capital test restrictions and the exclusion of land from IDBs will curtail effective use of IDBs for Wisconsin's economic development. In their place, we suggest however, that Congress adopt the workable restrictions on types of eligible projects found in Wisconsin law. This would ensure that IDBs were used to promote employment generating activities.

I would be happy to respond to any questions the Committee or any other member of the Congress might have.

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